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DISCUSSION PAPER

BETTER INFORMATION ON INTANGIBLES

WHICH IS THE BEST WAY TO GO?

[MONTH AND YEAR OF PUBLICATION]

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EFRAG welcomes comments on its proposals via the 'Questions to Constituents' at the end of each section. Such comments should be submitted through the EFRAG website by clicking [[here-insert hyperlink](#)] or should be sent by post to:

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Comments should arrive no later than [Comment Deadline Date]. EFRAG will place all comments received on the public record unless confidentiality is requested.

EFRAG Research Activities in Europe

This paper is part of EFRAG's research work. EFRAG aims to influence future standard-setting developments by engaging with European and international constituents and providing timely and effective input to early phases of the IASB's work. Four strategic aims underpin proactive work:

- engaging with European constituents to understand their issues and how financial reporting affects them;
- influencing the development of International Financial Reporting Standards ('IFRS Standards'), including through engaging with international constituents;
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our research work and current projects is available on EFRAG's website.

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Executive Summary

ES1 [Text to be included].

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QUESTIONS TO CONSTITUENTS

EFRAG invites comments on all matters in this Discussion Paper, particularly in relation to the questions set out below. Comments are more helpful if they:

- address the question as stated;
- indicate the specific paragraph reference to which the comments relate; and/or
- describe any alternative approaches that should be considered.

All comments should be received by [Submission date].

Question 1 Issues with the current information

Chapter 2 illustrates claimed issues with the current information on intangibles. Do you think issues exist that are not mentioned in the Chapter? If so, which?

Question 2 Which way to go?

Chapters 3, 4 and 5 present possible different approaches (namely recognition and measurement, disclosure of information on specific intangibles and information for assessing how performance could be affected by changes in intangibles) and, within each approach, different alternatives to provide better information on intangibles.

Do you think better information on intangibles should primarily be achieved by:

- a) Amending existing recognition and measurement requirements for intangibles (if so, please provide your responses to questions 3 – 7 and 11 below);
- b) Amending disclosure requirements for information on specific intangibles (if so, please provide your responses to questions 8 and 11 below);
- c) Amending disclosure requirements for information for assessing how performance could be affected by changes in intangibles (if so, please provide your responses to questions 9 - 11 below); or
- d) A combination of the above (if so, please describe the combination and answer the questions below related to the approaches you would combine and Question 11)?

Question 3 Recognition and Measurement

Chapter 3 considers whether and how internally generated intangibles could be recognised and measured in the financial statements and the benefits and limitations of the proposed approaches. In doing so, consideration is being given to the asset recognition in the statement of financial position but also to the effects in the statement of financial performance.

Do you consider that IAS 38 should be amended to permit the recognition and measurement of certain internally generated intangible assets? YES / NO (Please explain)

Question 4 Possible scope for recognition

Paragraph 3.14 explains that IAS 38 currently include an explicit prohibition to recognise some types of internally generated intangibles such as internally developed brands, mastheads, publishing titles, customer lists and items similar, staff training, marketing.

Do you consider that the explicit prohibition to recognise some types of intangible that exists in IAS 38 should be removed and replaced by a principle-based approach?

Yes/No(Please explain)

Question 5 Possible scope for recognition

Paragraphs 3.9 to 3.52 explore Four possible approaches regarding the recognition of internally generated intangibles. Which of the following approaches would you support?

- a) Capitalise all costs associated with defined intangibles; with no specified conditions or thresholds;
- b) Conditional capitalisation;
- c) Threshold for capitalisation; and
- d) No recognition (ie. expensing all internally generated intangibles).
- e) None of the above, Others (please explain).

Please explain the reasons for your preferences.

Question 6 Possible recognition criteria

If you support recognition based on Threshold or conditional in the previous question; which criteria would you consider for recognition:

- a) Criteria based on the level of (un) certainty about the outcome of the intangibles (i.e probability of expected benefit and the pattern of consumption of these future benefits);
- b) Criteria based on the identifiability of the expenditure related to the intangibles;
- c) Criteria based on the technical or commercial feasibility of the intangibles considered at inception of the development;
- d) Criteria based on separability of the assets that is the existence of legal right and/or the ability to sell, transfer, licence, pledge ..the asset);
- e) All or a combination of the above depending on the nature of the intangibles (please explain);
- f) Others (please specify).

Question 7 Possible measurement bases

Paragraph 3.53 to 3.70 consider possible measurement bases for internally generated intangibles without forming a final or suggesting a preferred approach. Which of the following suggested approach would you support:

- a) Initial and subsequent measurement at amortised cost with impairment (Cost model);
- b) Initial measurement at cost and subsequent measurement at fair value ('Revaluation model');
- c) Initial and subsequent measurement at fair value (fair value model);
- d) Initial measurement at fair value (as deemed cost) and subsequent measurement at amortised cost with impairment ('IFRS 3 model)?

Question 8 Information relating to specific intangibles

Chapter 4 discusses the requirement to disclose information that directly relates to the value of an intangible. Direct information could relate to the value of the intangible itself or to items linked to the intangible that would help a user of financial reports assess its value. Preliminary feedback by some preparers and investors indicates that the disclosure of the fair value of unrecognised intangible assets would involve significant costs and that the information may not be relevant to users of financial reports. Therefore, the focus of the proposed direct information alternative is on items linked to the key intangibles that would help users of financial reports assess their value. Examples of these items could be: for a pharmaceutical patent, information on the expiration date or on the targeted population; for a customer list the attrition rate.

- 1 Do you agree that direct information on intangibles should be limited to the key intangible assets of the entity? If not, why should it reach a broader scope?
- 2 Do you agree that the disclosure of the fair value of an intangible is less helpful for users of financial reports and less feasible for preparers, as compared to the disclosure of quantitative and qualitative information on the value of the intangible itself or to items linked to the intangible?
- 3 Do you agree with the identified advantages and disadvantages of direct information on intangibles compared to recognition, as identified in Chapter 4? If not, which aspects do you disagree with and/or which additional advantages and disadvantages have you identified?

Question 9 Information on uncapitalised costs related to future benefits

Chapter 4 proposes various information on costs of a period that are not capitalised, but could be considered to relate to benefits that will be recorded in future periods.

- 1 Do you consider that such information could be useful? If so:
 - (a) Should the information mainly complement information on specific intangibles (see Chapter 4) or should/could requirements on information for assessing how performance could be affected by changes in intangibles be introduced instead of requirements on information on specific intangibles?
 - (b) Should the information mainly:
 - (i) Reflect the views of the entity's management (e.g., by disclosing the costs the management considers relate to the benefits of future periods)? Or
 - (ii) Help users perform their own assessments on the costs related to the benefits of future periods (e.g., by providing further specifications and breakdown of the costs of a period)?
- 2 Do you agree with the identified advantages and disadvantages of information on uncapitalised costs related to future benefits identified in Chapter 4? If not, which aspects do you disagree with and/or which additional advantages and disadvantages have you identified?

Question 10 Information on factors affecting intangibles

Chapter 4 proposes information included in the financial reports on factors affecting intangibles should be limited to disclosing risk 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, relevant measures reflecting the risk, if relevant (e.g., KPI's used to measure it), and how the risk is managed and mitigated. It should include an assessment of the materiality of the risk factors based on the probability of their occurrence and the expected magnitude of their negative impact.

Do you agree with this proposal? If not, what information on factors affecting intangibles should be provided?

Question 11 Issues to be considered

Chapter 6 discusses challenges and issues to be considered when finding a manner to provide better information on intangibles. It mentions that it could be beneficial to introduce a common terminology on intangibles and that preparers of financial statements should not be required to disclose information on intangibles that would be (very) commercially sensitive.

- 1 Do you consider that it would be useful to introduce a common terminology on intangibles?
- 2 Do you agree that preparers of financial statements should not be required to disclose information on intangibles that would be (very) commercially sensitive?
- 3 Are there additional issues than those listed in Chapter 6 you think should be taken into account when considering how to provide better information on intangibles?

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CHAPTER 1: BACKGROUND

This Discussion Paper has been prepared as part of EFRAG's project Better Information on Intangibles. The Discussion Paper presents different approaches to get better information on intangibles based on input from members of the EFRAG Advisory Panel on Intangibles. The proposals are made for information on intangible sources of possible economic benefits (in the paper referred to as 'intangibles') to be included in financial statements, the notes to the financial statements and in the management report. The scope is limited to cover information that is useful for the primary users of financial statements.

Why this Discussion Paper?

- 1.1 In 2018, following the input received from the EFRAG research agenda consultation, EFRAG decided to add a research project on better information on intangibles to its agenda.
- 1.2 There has been a lot of debate in recent decades about how financial reporting does not provide a full picture of the value drivers of businesses. Internally generated intangibles such as know-how, market share, assembled workforce, research and so on, play an ever-increasing role in the performance of entities, but are not recognised in the IFRS financial statements.
- 1.3 Proponents of the research noted that:
 - a) Changes in the business landscape resulting from new technologies, digitalisation, software solutions and movements towards a service economy mean that internally generated intangible assets play an increasingly important role for the performance of an entity, while not adequately reflected in the financial statements.
 - b) There has been increasing focus on the intangible drivers of value within companies, and how these act as indicators of the future value of a business. At the same time, concerns have been voiced that financial statements are losing their relevance as they do not reflect many of these intangible elements.
 - c) The discrepancies between the accounting treatment for acquired and internally generated intangibles need to be examined as this is a significant investor concern as it distorts key ratios and could lead to the misallocation of capital.
- 1.4 As one of the first steps of the research, EFRAG commissioned an academic literature review to provide insights on primarily academic literature on information on intangibles, their relevance of financial reporting, company performance, market value and users. [The literature review](#) was published in 2020. One of the insights provided by the literature review was that although much research exists in the area of intangibles, not much research exists on how the information is used by users – and hence there is not much direct research on what information on intangibles would be useful for users.
- 1.5 EFRAG considered it important that suggestions on how to provide better information on intangibles would be based on identified information needs of users. EFRAG therefore conducted a limited number of interviews with users, academics and other types of stakeholders and established, in March 2020, the EFRAG Advisory Panel on Intangibles ('EFRAG API') which consisted of users of financial statements, valuers and preparers of financial statements to provide input to the project.

Input received from stakeholders

- 1.6 In identifying issues with current information on intangibles, EFRAG has considered input and feedback from:
- a) A limited outreach conducted in early 2019 with a range of stakeholders (including preparers, users, valuers, academics and other professional)
 - b) Several meetings of EFRAG API; and
 - c) Discussions of the EFRAG User Panel.
- 1.7 The input EFRAG has received has been relatively consistent with regards to the views that:
- a) The purpose of the financial statements is not to explain the market capitalisation of an entity by measuring all possible items at fair value;. Users were not so much interested in the fair value of individual assets as assessed by management than by obtaining the information necessary to make their own assessment of the business(es) of an entity as a whole.
 - b) The role of intangibles has significantly grown in importance and that information about intangibles can be improved (for this issue, the view has, however, also been expressed by a few that there is not much that can be done).
- 1.8 However, a wide range of views have been expressed about whether and how to improve information on intangibles from:
- a) Improved narrative reporting including metrics to assist users of financial statements in assessing an entity's intangibles;
 - b) Improved information about 'future-oriented' costs that are not recognised as assets; and
 - c) Further recognition of internally generated intangibles in the financial statements (or in a separate statement).
- 1.9 Most different views probably existed in relation to the recognition of intangible assets. Some considered that the current requirements are broadly right, while others considered that the requirements of IAS 38 *Intangible Assets* could be revisited. Among those, who considered that there is room for improvement, the views expressed included:
- a) Currently, too many intangible assets are recognised separately from goodwill in a business combination. From preparers of financial statements it is noted that it is very costly to account for these assets separately as it, for example, is necessary to assess whether the assets are impaired. From users, it is noted that many of the assets recognised separately are, in fact, just goodwill. Others, primarily users, consider that the current requirements are appropriate, as it is useful to receive information on what intangible assets an entity considers it has acquired in a business combination.
 - b) The criteria for the recognition of (internally generated) intangible assets may not be appropriate and could be revisited. Alternatives proposed included a wide range of views:
 - (i) All intangibles should be recognised (proposal from a user);

- (ii) The recognition criteria of IFRS 3 could also be applied for internally generated intangible assets if they can be measured reliably and it is more likely than not that their value will be recovered (suggestion from valuator);
- (iii) Internally generated intangibles should be recognised to the extent they can be sold and have a commercial value (suggestion from a preparer);
- (iv) Internally generated intangibles could be recognised to the extent they are identifiable within the entity's value creation process (suggestion from a user);
- (v) Internally generated intangibles should be recognised to the extent it is possible to sell them or they result from a contractual right and the cost can be measured reliably (suggestion from a user).

1.10 Different views also existed on how recognised intangibles should be measured. Some consider a fair value measurement to be most useful (measurement at fair value, initially and subsequently, was thus proposed in relation to recognition approach mentioned above in paragraphs 1.9b(i), 1.9b(ii)) while others suggest:

- a) Measurement at cost, unless fair value can be determined more reliably. In that case measurement should be at fair value both initially and subsequently for that intangible (this was suggested in relation to the recognition approach mentioned above in paragraph 1.9b(iii));
- b) A mixed measurement approach consisting of cost, a measure reflecting the revenue the intangible will generate and fair value (this was suggested in relation to the recognition approach mentioned above in paragraph 1.9b(iv));
- c) Measurement at cost (initially and subsequently) (this was suggested in relation to the recognition approach mentioned above in paragraph 1.9b(v)).

1.11 The input on recognition and measurement has been reflected in the discussion in Chapter 3 on whether and how amendments to the current recognition and measurement requirements in IAS 38 could result in better information on intangibles.

1.12 Better disclosures on intangibles is another manner to provide better information on intangibles that has been proposed. Some noted that such information would improve transparency. There are currently no prohibition for preparers to provide additional information on a voluntary basis, but preparers seem reluctant to provide additional information. Many reasons can account for this reluctance including the cost of providing the information (for example, it may be less costly to provide the information outside the financial reports), its commercial sensitivity and the fact that entities may be judged negatively if, for example, they provide information on investment in intangibles (such as research cost for example) and the projects to which these investments relate are subsequently be abandoned.

1.13 The proposals in Chapter 4 build on input received on how direct information on intangibles (i.e., information useful for estimating the value of intangibles) can be provided to provide better information on intangibles.

1.14 As an alternative to change the recognition criteria and/or measurement of intangible assets and/or provide direct information on intangibles, users have explained that better information to determine the 'steady-state' margins and possible changes to these should be provided. The proposals in Chapter 5 are based on this approach and the suggested information to be provided is accordingly presented in Chapter 5.

- 1.15 Some users have also pointed out that ESG disclosures (that is, disclosure of data explaining a business's impact and added value in the areas: environment social and corporate governance) and other types of non-financial disclosures are useful. However, other users have noted that only 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.
- 1.16 Non-financial information is considered in Chapter 4 and Chapter 5 of this Discussion Paper to the extent this information is considered to be useful for the primary users of financial reports, for example to the extent the information can be considered pre-financial (that is, although not currently affecting the entity, it could be assumed that in the future, the factors on which information is provided, would be important for the entity's performance).
- 1.17 As it appears above, the preliminary input received for this Discussion Paper has pointed in different direction. The absence of a consensus on which way to go means that there, even after decades of discussions, is still a need to consider the topic – both in this Discussion Paper and in other similar initiatives. Different approaches on how to provide better information on intangibles have already been developed. With these different approaches already developed, input is needed on which one (or combination of approaches) should be considered further.
- 1.18 Accordingly, this Discussion Paper does not present 'one single model' to provide better information on intangibles but, instead, discusses the merits and limitations of various approaches.

Scope

- 1.19 This Discussion Paper only considers information to be provided in the primary financial statements, the notes to the financial statements and in the management report. The scope is also limited to only cover information that is useful for the primary users of financial reports. Information to meet the needs of stakeholders other than those defined as the primary users of financial reporting in the Conceptual Framework (that is, existing and potential investors, lenders and other creditors) is not part of this research.
- 1.20 The Discussion Paper considers information on intangible sources of possible economic benefits other than financial assets. That is, the intangible sources should have the potential to produce economic benefits on a stand-alone basis or together with other intangible sources of possible economic benefits. In this Discussion Paper these intangible sources of possible economic benefits are referred to as 'intangibles', as opposed to 'intangible assets'. The Discussion Paper thus uses the term 'intangibles' to include a potentially wide range of assets and other factors that drive the creation of value in companies, whether or not they are currently recognised or reported in financial reports and whether or not they would meet the accounting definition of an asset. The scope of this Discussion Paper is thus broader than many other projects which only consider intangibles that would meet the definition of an asset.
- 1.21 This Discussion Paper focuses on intangibles in relation to providing information on how an entity creates, maintains, expands and/or preserves value. There are many other issues related to financial reporting of intangibles (including divergence in how (the scope of) IAS 38 is applied/interpreted). Such issues are not the main focus of this Discussion Paper.
- 1.22 As it will appear, the purpose of this Discussion Paper is not to consider how the book value of an entity should equal its market capitalisation.

- 1.23 The proposals in this Discussion Paper are only intended for material information about intangibles that are key for value creation or, for the proposals in Chapter 5, entities for which intangibles are material.

Structure of the Discussion Paper

- 1.24 The Discussion Paper considers approaches to better information on intangibles in relation to:
- a) Recognition and measurement in the primary financial statements (Chapter 3);
 - b) Information on specific intangibles in the notes to the financial statements or in the management commentary (Chapter 4);
 - a) Information for assessing how performance could be affected by changes in intangibles in the notes to the financial statements or in the management commentary (Chapter 5).
- 1.25 Chapter 6 considers factors, primarily from the perspective of preparers, that will have to be considered when finding a solution to provide better information on intangibles.
- 1.26 First, however, the following chapter, Chapter 2 summarises some of the issues with current information on intangibles.

CHAPTER 2: ISSUES WITH THE CURRENT INFORMATION

EFRAG's commissioned literature review, published in February 2020, identified academic studies showing that the value relevance of financial statements is decreasing and that this could be due to financial statements not reflecting information about intangibles, which has become more important for more entities than previously. Insufficient information on intangibles could affect the company's market value performance due to information asymmetry, result in an inefficient capital allocation in society and make assessment of the management's stewardship difficult. The said review also underlined the difficulty, for users, to compare entities that grow organically with those growing by means of acquisition, as current regulation generally requires acquired intangibles to be recognised, while internally generated intangibles can only be recognised in specific circumstances.

Some consider that recognising more internally generated assets (and perhaps fewer intangible assets acquired in a business combination) would be a manner to deal with the issue. However, both measurement at cost and at fair value of recognised intangible assets is problematic. In addition, not all intangibles would meet the definition of an asset.

Additional disclosures as the way forward also have some problems. Boundaries between different intangibles are not (well) defined and interpreted differently. There are also no generally accepted manners on how to report on intangibles. Finally, additional information on intangibles may be commercial sensitive information to provide.

What are the issues with the current information on intangibles?

- 2.1 Intangibles are dissimilar, which complicates finding manners on how to account for them. In addition, many intangibles have specific characteristics, in addition to lacking physical substance, and economic features that can be a challenge to the conventional approach of financial reporting. Some of these characteristics are:
- a) Investment in intangibles is generally associated with high levels of uncertainty about the expected future benefits. In addition, costs of developing an intangible are often sunk costs. The development costs cannot be recovered if the development is not satisfactorily finalised. If the investment fails it cannot even be sold as scrap.
 - b) It can sometimes be difficult to demonstrate the control over intangibles when it is difficult to restrict access or protect the use by legal means.
 - c) On its own, the value of an intangible can be very low. It is how it works in combination with other intangibles or other assets that makes it valuable. The existence of synergies and network effects are an important feature of intangibles and most intangibles do not create value on their own but in conjunction with other assets and the existence of synergies can affect their value and gives rise to difficulties, for example in relation to measurement.
 - d) It is often scalable at low marginal costs. Scalability means that unlike tangible assets, intangibles can be used repeatedly and in multiple places at the same time, with little or no reinvestment.

- 2.2 To add to the complexity of the debate on the current information on intangibles, there are different views on what the issues are. For example, while some consider that it is an issue that internally generated intangibles assets are not recognised, others point out that the omission of intangible assets from the statement of financial position is not necessarily a deficiency, as the value of intangible (and other) assets can be ascertained from the statement of financial performance. In addition, not all intangibles would meet the definition of an asset (see also Chapter 3).
- 2.3 The purpose of this chapter is thus not to summarise general acknowledged deficiencies with the current information. Instead, this chapter provides a summary of views on the problems with the current information.
- 2.4 Poor information on intangibles may affect:
- a) Company's market value performance and financial position;
 - b) Capital allocation and investment decisions;
 - c) Access to finance for investment in intangibles;
 - d) Stewardship assessments (the accountability of management for actions/decisions in managing a firm's resources).
- 2.5 Some academic studies show that the value relevance of financial statements is decreasing, and this could be due to financial statements not reflecting information about intangibles, which has become more important for more entities than previously. Some are concerned that many intangibles that would meet the definition of intangible assets are not recognised because of the additional recognition criteria in IAS 38 *Intangible Assets* for internally generated intangible assets. They argue that:
- a) This means that financial statements do not reflect the underpinning drivers of value for intangible intensive businesses. In this regard it is noted that the importance of intangibles is growing in the global economy where intangible assets such as big data, customer relationships, brand, efficient business processes, or the dynamic capability of a workforce, are an important part of how businesses create value. It is also noted that IAS 38 does not require, but only encourages, entities to 'provide a brief description of significant intangible assets controlled by the entity but not recognised as assets because they did not meet the recognition criteria'.
 - b) It distorts performance measures as:
 - (i) Return on assets ratios would not provide useful information as the 'assets' part would not be properly reflected. One of the consequences is that it is more difficult to hold management accountable for use of the entity's resources and the return on these.
 - (ii) As costs incurred to build an intangible are not capitalised, income of a period may not be correctly matched with the related expenses. Accordingly profit margins of a period do not say much about the 'real' profitability of the period and cannot be used to predict margins in the future.
 - c) It reduces comparability insofar as most intangible assets are not recognised if they are internally generated, but they are recognised if they are acquired. In addition, there may be a difference between whether intangible assets are

acquired in a business combination or not as under IAS 38 probability and reliability recognition criteria apply¹, whereas under IFRS 3 *Business Combinations* the criteria are always considered to be satisfied.

- 2.6 The issue of reduced comparability as a result of internally generated intangible assets generally not being recognised, while acquired intangibles being recognised means that it is difficult to compare entities that grow organically with entities that grow by acquisition². Particularly in relation to business acquisitions, the view has also been presented that too many intangible assets are recognised (separately from goodwill). The reliability and relevance of some of the separately recognised intangibles acquired in a business combination is thus questioned by some (both users and preparers). Others, however, consider that including intangible assets in goodwill, instead of recognising them separately, reduces information on what the entity has acquired in a business combination.
- 2.7 While some think that more internally generated assets should be recognised (and perhaps fewer intangible assets acquired in a business combination), it is also noted that not only the recognition, but also the measurement requirements of IAS 38 that results in some problems.
- 2.8 Under IAS 38, intangible assets are generally measured at cost. There are two issues with measurement at cost. Firstly, for internally generated intangible assets, it may be difficult to identify/allocate internal costs. Secondly, the measurement does not reflect the value of the asset, if, for example, it is worth much more than its cost price. This may particularly be an issue with some types of intangibles which increase in value as they are being used (for example, some software platforms). On the other hand, measurement at fair value would also be problematic particularly from a reliability/faithful representation perspective as there is no active market for most intangibles. Chapter 3 further discusses the respective merits and limitations of the different possible measurement bases for intangibles.
- 2.9 As an alternative to recognising more intangibles, additional disclosures could be provided. However, additional disclosures as the way forward also has some problems. Boundaries between different intangibles are not (well) defined and they are interpreted differently. There are also no generally accepted approaches on how to report on intangibles. Chapters 4 and 5 further discuss these issues. Finally, while additional information on intangibles may be useful, it could also mean that entities would have to provide information that is commercially sensitive. This issue is further discussed in Chapter 6.
- 2.10 Finally, when it comes to the current issues related specifically to intangibles that would meet the definition of an asset, there are also issues related to the current standards, such as:
- a) How to assess 'control' in relation to certain intangibles. For example, should control be assessed in relation to the right to be able to broadcast a given event

¹ IAS 38 requires an entity to recognise an intangible asset if, and only if: 'a) it is probable that the future economic benefits that are attributable to the asset will flow to the entity; and b) the cost of the asset can be measured reliably'.

² In its comment letter in response to the IASB's consultation on DP 2020/1 *Business Combinations—Disclosures, Goodwill and Impairment*, EFRAG invited the IASB to take into account the concerns of investors who want to compare companies that grow by acquisitions more easily with those that grow organically and, as such, start a project on IAS 38. Pending such a broader project on IAS 38, EFRAG questioned the usefulness of considering unilateral changes to the existing provisions in IFRS 3 as to whether some separately recognised intangible assets should be subsumed in goodwill. Instead, EFRAG suggested a broader project on IAS 38 by the IASB.

(together with other broadcasting companies) or to holding the master broadcasting rights for a given event?

- b) It is not always straightforward whether an asset should be accounted for under IAS 2 *Inventories* or IAS 38;
- c) It is not always straightforward whether an asset is a pre-payment or an intangible asset. For example, whether an upfront payment to be able to broadcast a given event would be a pre-payment for a service or the purchase of an intangible right;
- d) It is not always straightforward whether/when a contract could be considered an intangible asset.

2.11 It is not a given that the most important intangibles for an entity are those that would meet the definition of an asset. For the broader category of intangibles, some of the issues are:

- a) Information on intangibles is difficult to compare and use as the boundaries between different intangibles are not (well) defined and interpreted differently. Even for intangible assets there are different interpretations on what development costs are.
- b) It is unclear what the unit of account is. This also applies for acquired intangible assets. For example, a movie picture includes many different types of rights such as author rights, music rights and graphical rights. It is unclear whether these rights are different intangible assets or the intangible asset on which information should be provided is the movie picture.
- c) The information to be provided may be commercial sensitive (this issue is further considered in Chapter 6).

2.12 While this discussion paper focuses on the issues mentioned in paragraphs 2.5 - 2.8, the issues listed in paragraphs 2.9 - 2.11 are also considered important and are included in the assessments of the different approaches to provide better information on intangibles, when relevant.

CHAPTER 3: RECOGNITION AND MEASUREMENT

This chapter considers whether and how internally generated intangibles could be recognised and measured in the financial statements and the benefits and limitations of the proposed approaches. In doing so, consideration is being given to the asset recognition in the statement of financial position but also to the effects in the statement of financial performance.

As explained in Chapter 2 Issues with the Current Information, accounting for intangible assets under IFRS does not have an overarching framework, which creates a lack of comparability for otherwise similar intangible assets. Intangibles are generally recognised only if acquired, either separately or as part of a business combination. Intangible assets that are generated internally are generally not recognised in financial statements.

Internally generated intangibles that may be the most important for entities are not generally recognised as assets in the financial statements and accounting of many investments in intangible assets to the statement of financial performance results in confusing earnings from current revenues with investments to gain future revenues. It is therefore difficult to compare the financial statements of an entity that has built up substantial intangible assets internally with those of another entity that has purchased most of its intangible assets.

In considering the recognition and measurement of internally generated intangibles three questions need to be addressed:

- *Which type(s) of intangibles are considered fit for recognition and measurement;*
- *What are the recognition criteria for such intangibles; and*
- *Which measurement basis or bases should be considered?*

Which type(s) of intangibles should be considered for recognition

3.1 Intangibles encompass a wide variety of items and when considering recognition and measurement for such items a classification of intangibles is necessary. A possible classification considered in this Discussion Paper³ is related to the degree of difficulty of establishing ownership or control rights and more generally the difficulty of their measurement.

- **Category A:** Intangibles that are controlled by an entity; for which property rights are relatively clear and for which markets exist (generally they can be bought and sold). Within this category, two types of intangibles can be distinguished: (i) Assets such as patents, copyrights and trade names and (ii) Business agreements, licenses, enforceable contracts, and data bases.
- **Category B:** Intangibles that are controlled by the entity but for which well-defined and legally-protected property rights may not exist, and markets are weak or non-existent. Examples are R&D in process, business secrets, proprietary management systems, and business processes.
- **Category C:** Intangibles for which the firm has few, if any, control rights and markets do not exist, and which are often tied to the people who work for the entity. Examples are human assets, structural (or organisational) assets, and relational assets, i.e. the components of intellectual capital.

³ Classification suggested by Blair, M. M., & Wallman, S. M. H. (2000). Unseen wealth: Report of the Brookings task force on understanding intangibles sources of value.

- 3.2 Control is a fundamental concept in the definition of any asset's recognition in IFRS and it does seem unrealistic, or at least difficult, to introduce an exception to recognise 'uncontrolled' intangibles without unintended consequences on other assets or undermining the whole principles of IFRS. Therefore, focusing on possible improvement to the accounting of intangibles in categories A and B seems the more promising and realistic approach.
- 3.3 Before considering possible approaches for recognition and measurement of those internally generated intangibles as characterised above, the following section discusses a number of additional considerations specific to intangibles.

Existence of expenditures

- 3.4 Some types of internally generated intangibles typically do not require explicit (nor have easily identifiable) expenditures. This may be the case for instance for organisational capital, social capital, reputation, customer fidelity.
- 3.5 Although the IFRS definition of an asset does not state explicitly that an asset must stem from a direct or identifiable expenditure to be recognised, the absence of such direct or identifiable expenditure adds a layer of complexity to any recognition pattern: if the recognition of an intangible asset such as organisational capital, market power, customer loyalty, is proposed in absence of such any expenditure, the credit must be to equity, either directly to equity or as income through the statement of financial performance.
- 3.6 Some consider that the nature of an accounting system is to report faithfully on the cash-to-cash cycle, and therefore recognise only assets arising from expenditures (including commitments for future expenditures that give rise to a liability).
- 3.7 In this regard, it has to be noted that many promoters of the recognition of more internally generated assets⁴ generally restrict the accounting for intangible assets to the capitalisation of expenditures as their focus is on the effects on earnings of such expenditures and avoiding confusing earnings from current revenues with investments to gain future revenues.
- 3.8 These authors generally consider that limiting recognition to intangibles that have expenditure would be more helpful for users to measure return on investment and for the assessment of stewardship. Conversely, recognising assets with no expenditure could alter this information.

Possible approaches for the recognition of internally generated intangibles

- 3.9 Conceptually four possible approaches to recognition of internally generated intangibles could be considered which all have benefits and limitations.
- a) Capitalise all costs associated with defined intangibles; with no specified conditions or thresholds;
 - b) Conditional capitalisation;
 - c) Threshold for capitalisation; and
 - d) No recognition (ie. expensing all internally generated intangibles).

⁴ For example, Lev and Srivastava 2020.

Capitalising all internally generated intangibles

- 3.10 Some may argue that recognising all internally generated intangible assets would be appropriate as it would be consistent with the treatment of internally generated tangible property, plant and equipment. It has to be noted IAS 16 *Property Plant Equipment*, similar to IAS 38, requires that assets can only be recognised if (a) it is probable that the future economic benefits that are attributable to the asset will flow to the entity and (b) the cost of the asset can be measured reliably.
- 3.11 But the current definition of intangibles under IAS 38 requires, in addition, that Intangibles must be 'identifiable' that is either:
- a) Separable (capable of being separated and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract); or
 - b) Arise from contractual or other legal rights.
- 3.12 To be recognised, an asset must have boundaries and identifiability may be seen as a reasonable condition to set such boundaries of an asset which by essence has no physical substance and therefore no physical boundaries.
- 3.13 It has to be noted that, without changing the current requirements in IAS 38 some internally generated intangibles can already meet the conditions for recognition. Typically, intangibles in Category A would meet the identifiability criteria:
- a) A self-developed brand can often be separated out (e.g., sold or licenced).
 - b) Contractual customer relationships would meet the contractual-legal criterion, whereas customer loyalty or the entity's reputation would not meet either of the two Identifiability criteria in 3.11.
- 3.14 However, the above-mentioned intangibles are not currently recognised because IAS 38 includes specific prohibitions to recognise:
- a) Internally developed brands, mastheads, publishing titles, customer lists and items similar, IAS 38 includes an explicit prohibition to recognise such items; and
 - b) Expenditure on training staff, selling and administration.
- 3.15 Recognition of items in a) is prohibited on account of the fact that the cost of generating an intangible asset internally is '*often difficult to distinguish from the cost of maintaining or enhancing the entity's operations*' Recognition of items in b) is prohibited on account of the difficulty to demonstrate control.
- 3.16 A possible approach could therefore consist in removing the explicit prohibition and consider whether the guidance provided by IAS 38 to define 'identifiable' could be modified in a less restrictive/more inclusive way. That could be the topic of an IASB project in the context of its forthcoming agenda consultation.
- 3.17 The existing 'measurability' and 'probability of future economic benefits' conditions can also be an impediment to recognition of internally generated intangibles. Such conditions are assumed to be always met in the case an acquisition of intangibles in a Business Combination.

- 3.18 However, it seems difficult to suggest removing such conditions, since recognising assets that cannot be measured reliably (even if a fair value model is applied, initial recognition would be at cost) or that are unlikely to generate future economic benefits is not deemed to result in useful information.
- 3.19 In addition, asset recognition in the statement of financial position must be considered together with the effect on the statement of financial performance which materialise through amortisation and impairment. As discussed above, a feature is uncertainty about both the cost and the outcome of investments in intangibles and how that affects the usefulness of the information in particular in the statement of financial performance. In that respect, Mismeasurement of intangibles at the entity level might have adverse subsequent impacts on the in the statement of financial performance. (including through impairment or restatements to the carrying amount) thus resulting in providing inadequate information. In the presence of high outcome uncertainty, there is statement of financial performance mismatching effects, either through arbitrary amortisation or subsequent impairment.
- 3.20 Specific characteristics and economic features of internally generated intangibles contribute to that uncertainty can be a challenge to the conventional way of thinking about reporting and accounting because:
- a) The expenditure associated with some internally generated intangibles is not always separable from other expenses or may not be easily identifiable when it is imbedded in transactions also involving current expenses.
 - b) The economic benefits expected to be derived from investment in intangibles can be hard to quantify as it is the nature of innovation that many projects will fail and be abandoned and provide little or no benefit to the entity. For investments in activities such as research and development (say) with no product as yet, the amount and timing of future revenues is very uncertain.
 - c) The absence of market for most of these assets can affect the reliability of their measurement. There are no markets generating visible prices for items such as intellectual capital, brands, or human capital to assist investors in correctly valuing intangibles-intensive companies. This can create difficulties under both a fair value or cost model as under the latter, intangibles would need to be tested for impairment.
 - d) The existence of synergies and network effects are also important features. Most intangible assets do not create income on their own but only in conjunction with other assets and the existence of synergies and network effects can affect their value. This can give rise difficulties in connection to measurement (be it for fair value purposes but also for the measurement of consumption or impairment of intangible assets which are reported at cost, and the determination of values on an asset standalone basis).
- 3.21 In the IFRS Conceptual Framework, uncertainty about the existence of an asset or liability or a low probability of a flow of economic benefits is noted as circumstances when recognition of a particular asset or liability might not provide relevant information.

- 3.22 As outlined by some⁵, capitalising ‘assets’ with significant uncertainty aggregates them on the statement of financial position with assets with more certain outcomes thus blurring the overall information about future cash flows expectations. Capitalising investments in intangibles subsequently affects earnings as these recognised assets would be amortised against future earnings or subject to impairment. This in turn may affect the usefulness of the information provided by the statement of financial performance and the quality of Users’ analyses.
- 3.23 Accordingly, some consider that the uncertainty feature suggests a solution that books an asset to the statement of financial position when an uncertainty threshold or condition is satisfied. As mentioned in paragraph 3.1, measurement uncertainties are lower for some categories of intangibles that are controlled by an entity; for which property rights are relatively clear and for which markets exist.
- 3.24 However, it could be valuably argued that the same levels of measurement uncertainties exist in the case of Intangibles acquired in a business combination. The presumption that the ‘reliable measurability’ and ‘probability of future economic benefits’ conditions are always met for intangibles acquired in a business combination could be rebutted as the existence of a purchase price for a whole entity or business does not necessarily infer that the allocation to each identifiable intangible item would result in reliable and useful information.

Establishing a threshold for recognition

- 3.25 Current IAS 38 actually contains a combination of recognition thresholds and explicit prohibitions (see paragraph 3.14) for some types of intangibles. Intangible assets are recognised if, in addition to meeting the definition of an asset:
- a) They are ‘identifiable’ that is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged; or arise from contractual or other legal rights.
 - b) If it is probable that the future economic benefits that are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably.
- 3.26 Thresholds act as an in/out assessment made at inception when an entity starts the development of an intangible and incurring expenditure to recognition conditions (see next section) and not reassessed subsequently.
- 3.27 The identifiability criterion (which is embedded in the definition of intangible assets in IAS 38) de facto scopes out items such as customer service capability, presence in geographic markets or locations, strong labour relations, ongoing training or recruiting programs, knowledge capital, ecological attitudes, outstanding credit ratings and access to capital markets, or favourable government relations.
- 3.28 As explained in paragraph 3.14, IAS 38 includes specific prohibitions to recognise: internally developed brands, mastheads, publishing titles, customer lists and items similar and expenditure on training staff, selling and administration.

⁵ Accounting for Intangible Assets - Suggested Solutions (Richard Barker, Andrew Lennard, Stephen Penman, Alan Teixeira) – September 2020.

- 3.29 A possible option to consider could be to remove these explicit prohibitions and consider specific recognition thresholds that are not too high so as to cause investment expenditure to be expensed as incurred. The criterion of identifiability could also be removed from the definition of intangibles assets in IAS 38; considered as a threshold or condition for recognition and defined in a less restrictive way (see paragraph 3.16).
- 3.30 Some have suggested that an alternative threshold could consist in the ability to determine, at inception of an investment the amortisation schedule that allocates the consumption of those assets to appropriate periods.
- 3.31 More particularly proponents of such an approach, considers as possible alternative approach to recognise an asset only when:
- a) expenditure has been incurred, that is separately identifiable from other transactions; and
 - b) the entity has the ability to establish and allocated the pattern of consumption of future benefits (that is to establish an ex-ante amortisation schedule) arising from that asset to appropriate periods.
- 3.32 A limitation of such an approach is that it would not address the situation of intangibles infinite (or indefinite) lives nor the situation of intangibles with no (identifiable) expenditure.
- 3.33 Other possible recognition conditions of internally generated intangibles could encompass the following criteria (alone or a combination
- a) Intangibles with attributable benefits only (that is intangibles for which future benefit can be identified and separated from the other main business activities at inception of their development) that can be identified and estimated at inception of the development;
 - b) The ability to estimate, at inception of the development of an intangible the expected expenditure related to that intangible (e.g. R&D, development of a customer database or brand...);
 - c) Whether the cost associated with the development of the intangibles are, at inception of the development, expected to be recovered;
 - d) Whether the item is identifiable within the entity's value creation chain; that is, for instance the ability to attach a rate of return to the investment;
 - e) Whether the intangible can be sold or has a commercial value;
 - f) Whether monitoring for impairment can be established (i.e., whether the recoverable amount can be determined).
- 3.34 An option of the threshold approach could consist in considering the criteria for recognition set in IFRS 3 and recognise all internally generated intangible that would have been recognised if acquired separately. IFRS 3 allows the recognition of a broad range of intangibles that are separately identifiable including:
- a) Marketing-related intangible (such as trademarks, trade names, internet domain names and non-competition agreements);
 - b) Customer-related intangible (such as customer lists, customer contracts and customer relationships);

- c) Artistic-related intangible assets (such as books, pictures, musical works and audio-visual material);
 - d) Contract-based intangible assets (such as licensing agreements, servicing contracts, employment contracts and use rights).
- 3.35 Separate presentation of expenditure not meeting the defined thresholds in the statement of income could also be considered (See Chapter 5).

Conditional capitalisation

- 3.36 Conditional capitalisation is a permutation of the 'Thresholds' approach in which the thresholds are not assessed once and for all at inception of the development of an asset but on the contrary, as time evolves, an entity reconsiders if the threshold has been met and if it becomes likely that the investment will pay off, capitalisation would start at that point in time.
- 3.37 Under this approach expenditures are expensed (or capitalised and immediately impaired) immediately to indicate their relative uncertainty, but presented in a separate line of the statement of financial performance so not to be confused with other operating expenses. When the threshold for recognition is met, an asset starts to be recognised and is then subsequently amortised.
- 3.38 An illustration of 'conditional capitalisation' can be found in the pharmaceutical sector, where some companies have developed practice to start manufacturing inventory before the developed drugs are approved, in anticipation of receiving that approval (pre-approval inventory). Inventory is recognised as an asset under IAS 2, but its recoverable amount is assessed for impairment 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.
- 3.39 Another illustration of 'conditional capitalisation' can be found in the accounting of development costs. Such costs are expensed until the point in time when the project technical and commercial feasibility have been established.
- 3.40 The practical solution, put in place by the pharma industry for inventories could be considered and extended to different forms of intangibles; including research cost, training cost and marketing expenses.
- 3.41 It has to be noted that IFRS permits recognition and immediate impairment of some assets and allows conditional capitalisation through the requirement to reverse impairments for all assets, including intangibles, except goodwill, if the recoverable amount increases.
- 3.42 Separate presentation in the statement of income of the expenditures that do not meet the condition for recognition can supplement this approach. See Chapter 4 and 5).

- 3.43 An example of conditional recognition can be found in the practices of the extractive industries. Under the so-called 'successful efforts' method used in the oil and gas industry to capitalise, for each individual exploratory well, costs associated with the location of new oil and gas reserves. Costs may be capitalised as wells-in-progress until there is additional information about the existence of future benefits and as soon as the additional information becomes available, these costs can either be charged to expense (if there are no future benefits) or reclassified as a fixed asset (if there are future benefits). In the latter case, these costs are amortised as production occurs, so that expenses offset revenues.
- 3.44 Applying the conditional capitalisation approach, research and development cost could be either capitalised and impaired (or expensed) until the specified conditions are met (for example outcomes of a research project are known and future economic benefits from the research become likely to flow to the entity). The amortisation expense would then be recognized over the periods where the benefits from the R&D materialise in revenue. The reversal of the impairment loss would indicate to users when the management has assessed that its R&D would pay off. Compared with current IAS 38, which requires expensing research cost and provides high hurdles for capitalising development cost, this approach could be considered to better match revenue and expenses.

Expensing internally generated intangibles

- 3.45 This is the default accounting when intangibles are not separately identifiable or do not meet the conditions in current IAS 38.
- 3.46 The immediate expensing of investment in intangible assets to the statement of financial performance, 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).
- 3.47 However, separate presentation in the statement of financial performance could partly help address the issue by distinguishing expenses that relate to investments in intangibles from other operating expenses. See the discussion in Chapter 5. In addition, expanded disclosures about internally generated items that meet the definition of intangible asset but not the recognition criteria, might provide users with additional information to assist in analysing similar companies in industries in which intangible items are significant to future prospects.
- 3.48 This could address concerns raised by some that the benefits of recognising internally generated intangible assets on the statement of financial position do not justify the related financial reporting costs. Incremental disclosure could provide useful information at a reasonable cost. It has to be noted that disclosures about unrecognised intangible assets would not be unprecedented: IAS 38 already:
- a) Requires entities to disclose the aggregate amount of research and development expenditure recognised as an expense during the period.
 - b) Encourages, but do not require, to disclose '*a brief description of significant intangible assets controlled by the entity but not recognised as assets because they did not meet the recognition criteria in this Standard or because they were acquired or generated before the version of IAS 38 Intangible Assets issued in 1998 was effective*'. [IAS 38 Par 128]
- 3.49 The question arises as to whether mandatory and expanded disclosures would not be preferable to voluntary ones to achieve more comparability.

- 3.50 In practice, given the general requirement in IAS 1 *Presentation of Financial Statements*, to provide any additional information (even if not required by a specific Standard) necessary for an understanding of the entity's performance and financial position, one would expect companies to disclose information on significant risk factors and managerial judgement relative to material levels of investments in intangibles, whether capitalised or not.
- 3.51 The nature and extent of information to be disclosed in the notes would need to be specified, while balancing the desire for incremental disclosure from users with concerns of preparers about providing proprietary information.

Advantages and disadvantages of the four possible approaches

- 3.52 The table below summarises the pros and cons of the four approaches discussed in the Chapter:

| | Advantages | Disadvantages |
|--------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| All capitalised | <p>Comparability between acquired and self-developed intangibles.</p> <p>Comparability between internally generated tangibles and intangibles.</p> | <p>Difficulty/ impossibility to separately identify and measure some intangibles.</p> <p>Due to the measurement uncertainty, possible mismatches effects in Statement of Financial Performance, either arbitrary amortisation or subsequent impairment.</p> <p>Possible incompatibilities with the conceptual framework (absence of control...)</p> <p>More costly of the 4 approaches as preparers are required to identify and measure all intangibles.</p> |
| Thresholds for capitalisation | <p>Addresses the uncertainties inherent to measurement of intangibles by considering recognition threshold.</p> <p>When threshold is met, reduces possible mismatches in the statement of income due to expensing expenditure on intangibles before revenue is recognised.</p> | <p>If too high capitalisation thresholds would continue to exclude most internally-generated intangibles leading to no improvement on current accounting.</p> <p>Criteria for recognition are not reassessed even if subsequently met leading to more exclusions than conditional capitalisation.</p> <p>Does not fully address the lack of comparability with acquired intangibles if internally-generated intangibles are initially measured at cost not fair value like for IFRS 3 and as the scope of possible recognition of purchased intangibles under IFRS 3 would probably still be larger.</p> <p>Cost of implementation.</p> |

| | Advantages | Disadvantages |
|-------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Condition for capitalisation | <p>Addresses the uncertainties inherent to measurement of intangibles by considering recognition conditions.</p> <p>When threshold is met, reduces mismatches in the statement of income due to expensing expenditure on intangibles before revenue is recognised.</p> <p>As conditions for recognition are subsequently reassessed more IGAs can be captured.</p> | <p>Does not fully address the lack of comparability with acquired intangibles if internally-generated intangibles are initially measured at cost not fair value like for IFRS 3 and as the scope of possible recognition of purchased intangibles under IFRS 3 would probably still be larger. .</p> <p>Cost of implementation.</p> |
| All expensed | <p>Less costly of the 4 approaches for preparers.</p> <p>Avoid subsequent mismatching from amortisation or impairment due to uncertainty about future revenues.</p> | <p>Mismatches of expenses and future revenue.</p> <p>Lack of comparability with acquired intangibles.</p> |

Which measurement basis or bases should be considered?

- 3.53 One of the factors to be considered when selecting a measurement basis is the degree of measurement uncertainty. The Conceptual Framework states that for some estimates, a high level of measurement uncertainty may outweigh other factors to such an extent that the resulting information may have little relevance.
- 3.54 The concluding remarks of the Academic Literature on Intangibles issued by EFRAG⁶ in 2020 identified that a key issue about reporting on intangibles is uncertainty:
- ‘Investment in intangibles is associated with high levels of uncertainty. Further, while there is evidence that investment in intangibles leads to innovation and tangible investment, there is a time lag between intangible investments and economic benefits (intangible investment occurs early in the product life cycle)’;*
- ‘the more the system is grounded on intangibles, the more vulnerable it becomes because intangibles are more uncertain, unstable and risky. The challenge we accountants face is to learn how to manage and report on these ‘invisible’ resources for a better understanding of organisations’ financial performance and their resilience’.*
- 3.55 Some may argue that it is not necessary to answer the cost/fair value question for internally generated intangible assets, since current IAS 38 allows intangibles to be subsequently accounted for at either cost or fair value (through equity).

⁶ A Literature Review on the Reporting of Intangibles – February 2020 ([here](#)).

- 3.56 However, retaining the choice between cost and fair value has greater implications in the context of internally generated intangible assets than for most other asset classes given the number and significance of internally generated intangible assets that do not have directly attributable costs. Therefore, the absence of a specified measurement basis (i.e. the option between cost or fair may give rise to an even greater lack of comparability than is the case today where internally generated intangibles are generally not recognised.
- 3.57 In that regard, it is noted that measurement at both cost and at fair value may be problematic:
- a) For fair value measurement, an issue is that there is no active market for most intangibles.
 - b) For measurement at cost, the issue is that it can be difficult to identify / allocate internal cost.
- 3.58 The following paragraphs discuss the pros and cons of cost or fair value measurement without forming a final or suggesting a preferred approach.

Arguments for and against cost

- 3.59 Arguments in favour of initially and subsequently measuring internally generated intangible assets at cost rather than fair value include that it is more consistent with the treatment of internally generated tangible property, plant and equipment. Furthermore, some argue that it is more consistent with IFRS 3 principles because IFRS 3 uses fair value only as a surrogate for cost for allocation purposes (see for example paragraph 33 of IAS 38).
- 3.60 Given the users' general focus on cash flows (and hence on the cost basis), fair value measurement of internally generated intangible assets for financial reporting purposes is considered by some as unnecessary. Financial analysts often see their role as determining value and therefore a fair value asserted by an entity's management is not particularly helpful other than as a point of comparison.
- 3.61 In outreach conducted during the development of this Discussion Paper, some users have indicated that recognition at cost would be a helpful measure to calculate return on investment. Others have considered that recognition of intangible items at cost does not result in providing useful measures of the benefit a company will receive from those expenditures.
- 3.62 Capitalisation of an intangible asset at cost is appropriate only where the costs to be incurred on development of an intangible asset can be identified and estimated reliably. This may be a particularly acute issue as expenditure on intangibles to generate future earnings are often made together with those for current earnings: For instance, a bonus to employees may represent investing in human capital and/or an incentive to stay with the firm and/or wages for past service. Advertising can generate future sales (brand building) as well as current sales.
- 3.63 Lastly, measurement at cost is generally understood to be less costly to produce than fair value measurement, as well as less subjective. It is seen as a cost-effective way of measuring internally generated intangible assets and relies on traditional recognition triggers (incurrence of cost), rather than effectively using reporting date as a recognition trigger. Subsequently, subjecting those assets to impairment testing only where impairment indicators exist indicated is also more cost-effective than a periodic valuation-based model.

Arguments for and against fair value

- 3.64 Arguments in favour of measuring internally generated intangible assets, at fair value include that fair value provides more relevant information by capturing the expectations of future cash flows generated by an asset and results in a consistent treatment of the same kind of assets acquired in a business combination under IFRS 3. However, assets acquired in a business combination are not subsequently remeasured at fair value.
- 3.65 Conceptually, four measurement options can be considered for the sake of the discussion:
- a) Internally generated intangibles are initially and subsequently measured at cost consistent with the current 'cost model' of IAS 38
 - b) Internally generated intangibles are initially measured at cost and subsequently measured at fair value, consistent with the current 'revaluation model under IAS 38).
 - c) Internally generated intangibles are initially measured at fair value which becomes their deemed cost and subsequently subject to amortisation and impairment (consistent with the accounting of separately identifiable assets and liabilities in a business combination under IFRS 3).
 - d) Internally generated intangibles are measured at fair value both initially and subsequently.
- 3.66 Fair value may also be the only option available when no expenditure is incurred (or is identifiable) for a specific nature of intangibles. A fair value measurement also avoids the need to identify and allocate cost to recognised assets which can be judgemental and burdensome.
- 3.67 Fair value is also more prone to capture the synergies between intangibles than cost accounting, as it is future-oriented insofar it encompasses expected future cash flows. However, this can be a double-edged sword with a risk of double counting of certain items when the effect of synergies starts materialising in the statement of income. However that effect would be mitigated if intangibles are initially measured at fair value but subsequently measured at cost (as explained in 3.65c) as the asset would be amortised when the synergies start materialising.
- 3.68 Fair value may have more relevance than historical cost for users but, in the case of intangibles it would be mostly based on unobservable inputs, since there is little or no active market for intangibles (most intangibles) and they may be not tradeable separately. In these conditions, fair value measurement would imply more subjectivity and expose financial reporting to a higher degree of uncertainty. For many intangibles, the measurement uncertainty of fair value could call into question whether it could provide a representationally faithful depiction.
- 3.69 A lack of consistency in the valuation methods and models adopted (for example proprietary models developed) may lead to lack of comparability). Fair value may also create volatility in profit or equity. Absent arm's length transactions for internally generated intangible assets, this will leave no basis for recognition other than the application of the cost method.

- 3.70 Fair value measurement may however be more costly to apply (all the more if intangibles are subsequently measured at fair value at the end of each accounting periods) that cost accounting and more difficult to justify on cost-benefit grounds and it may be questionable whether the benefits will always outweigh the costs incurred by the entity in determining fair value. Also separate initial measurement of identifiable intangibles at fair value has received criticisms for being costly and resulting in information that is not always used by users.
- 3.71 The table below summarises the possible effects of the measurement options considered in this Chapter on the statement of financial performance:

| | Initial measurement | Subsequent measurement | Changes in FV | Amortisation Impairment |
|-------------------------|----------------------------|-------------------------------|----------------------|--------------------------------|
| Cost model | Cost | Cost | N/A | P&L |
| Fair Value Model | FV | FV | P&L | N/A |
| IFRS 3 model | FV | Cost | N/A | P&L |
| Revaluation mode | Cost | FV | OCI | P&L ⁷ |

Conclusion for Chapter 3

- 3.72 Proponents of an expansion of the capitalisation of intangibles have generally not proposed a mechanical capitalisation of all intangibles. Instead, most recent research papers⁸ proposed only a limited expansion consistent with the current definition of assets under condition or thresholds such as the ability to attribute benefits or the passing of specified technological or commercial feasibility tests.
- 3.73 It is likely that, within the confines of the current definition of assets in IFRS, many intangibles identified as Category A in paragraph 3.1 could be made eligible for recognition under specified thresholds or condition. For other types of intangibles (identified as categories B and C in paragraph 3.1) alternatives to (or supplement to) capitalisation are being considered.
- 3.74 This Discussion Paper does not express a preference for a cost or fair value model for the initial and subsequent measurement of internally generated intangibles. As explained paragraph 3.59 to 3.70 both methods have their merits and limitations and this Discussion Paper is asking input from constituents on the matter.

⁷ The effect of increase in carrying amount of an asset as a result of revaluation is included in other comprehensive income (OCI), but the decrease and impairment losses impact P/L. However, increase will be included in P/L to the extent of previous decreases and impairment losses and, similarly, decreases are included in OCI to the extent of previous accumulated increases.

⁸ Gu and Lev (2017); Barker and Penman (2017).

CHAPTER 4: INFORMATION RELATING TO SPECIFIC INTANGIBLES

This chapter discusses the proposal to require the disclosure of information that directly relates to the value of an intangible or items linked to the intangible that would help a user of financial reports assess the value of that intangible, also referred to as 'direct information'. Intangibles are increasingly acknowledged as significant value drivers for the strategy and business model of an entity. The benefits of recognising intangibles may be questionable and may not outweigh the costs, particularly if there is no single recognition method that satisfies the needs of users. Thus, providing information disclosures relating to specific intangibles allows an entity to identify and provide the necessary and useful information on its key intangibles using fewer assumptions compared to recognition, while keeping the process less costly and avoiding the complexities of recognition. Since the disclosure of the fair value of unrecognised intangibles would involve significant costs and judgement (similar to their recognition at fair value) and the information may not be reliable due to measurement uncertainty, the focus of the direct information alternative is on items linked to intangibles, that would help users of financial reports assess their value. Information relating to specific intangibles could follow a qualitative approach, a quantitative approach or a mix of both.

Direct information on intangibles

- 4.1 Recognition of intangibles is not the only way to provide useful information to users of corporate reports. In practice entities, particularly in intangible-intense sectors, voluntarily disclose qualitative and quantitative information that helps users develop their own estimates of present value of the cash flows expected from internally generated intangibles.
- 4.2 This chapter discusses the alternative of a requirement to disclose information relating to a specific intangible, also described as 'direct information', for those intangibles identified by an entity to be its key intangibles. Direct information encompasses information directly linked to a specific intangible, be it recognised in the financial statements or not. This information could be with regard to:
 - a) The value of the intangible; or
 - b) Items linked to the intangible that would help a third party assess its value.
- 4.3 Disclosures directly related to a particular intangible include, for example, the economic life of the intangible (if relevant); the selling price of products developed based on the intangible; the type of the intangible (whether it would need to be replaced; whether it is maintained through the operation of the entity; whether it tends to increase in value when being used by customers).
- 4.4 Information relating to specific intangibles may take the form of qualitative information as well as quantitative information, which can be complementary. Examples of elements of qualitative and quantitative information on specific intangibles are provided in paragraph 4.21 below.

Why information relating to specific intangibles is useful

- 4.5 Intangibles are a crucial element of valuation, and are increasingly acknowledged as significant value drivers for the strategy and business model of an entity. Information relating to specific intangibles allows users of financial reports to understand the value creation aspects of intangibles.

- 4.6 In the European Commission consultation for the revision of the EU Non-Financial Reporting Directive⁹, half of the respondents took the position that companies should be required to disclose additional non-financial information regarding intangible assets or related factors. This view was stronger amongst users (59%). In addition, some financial authorities pointed out that intangibles provide essential information about an issuer's value creation potential and the lack of disclosure surrounding intangible assets creates an information gap between information available to issuers and that available to investors.
- 4.7 The importance and usefulness of information on intangibles is analysed in the report of the multistakeholder Task Force (the 'Task Force') established by EFRAG to undertake preparatory work for possible EU non-financial reporting standards in a revised NFRD¹⁰. The Task Force observes that the role of intangibles which are not reflected through financial reporting, and which are key to the development of businesses and to their processes of sustainable value creation, should be emphasised in sustainability information provided by entities. The Task Force notes that sustainability information tends to eventually lead to financial consequences meeting recognition criteria for inclusion in the financial statements over time. This makes the connectivity between sustainability information and financial information particularly relevant for users to monitor the reporting entity's value creation.
- 4.8 To understand value creation at company level, additional information is essential. This is illustrated by the increasing disconnect between financial reporting 'book values' and market values of companies, as expressed by financial markets through transactions. This situation explains why in the EU a majority of financial stakeholders support the idea of developing disclosures that foster a better understanding of intangibles. Information relating to specific intangibles is important in order to provide users the information about unrecognised intangibles as value drivers. This is particularly true for intangible-intensive sectors.

Proposals for information relating to specific intangibles

- 4.9 Information on the key intangibles of an entity can better serve the needs of users, if it relates to the entity's business model and is linked with financial performance measures.
- 4.10 To overcome the limits of current IFRS requirements, IFRS preparers in the more intangible-intensive segments (e.g., biotech, pharmaceuticals and health care equipment & supplies; interactive media and software; household products, personal products, textiles and apparel & luxury goods) have developed practical ways to integrate the information required by users. This direct information however is currently mainly included in presentations to investors and press releases, not captured by financial reports, not audited and, despite some market discipline that helps to achieve some degree of comparability within the same segment, the information provided is generally not comparable across entities and across segments.

⁹ <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Fina/public-consultation>

¹⁰ [Proposals for a relevant and dynamic EU sustainability reporting standard-setting](#), European Lab Project Task Force on preparatory work for the elaboration of possible EU non-financial reporting standards (February 2021).

Suggestions on direct information to be provided

- 4.11 In the following paragraphs, this paper presents a possible approach to provide better information on intangibles, requiring the disclosure of direct information about key intangibles.

Identification of key intangibles

- 4.12 The starting point would be for an entity to identify its key intangibles. Key intangibles would be those that are critical to the business model of an entity, and that are the main driver for an entity's value creation.
- 4.13 These identified intangibles would then be those for which required qualitative disclosures and key standardised intangible-related metrics would be required, supplemented by entity-specific metrics. The fact that entities would be required to provide similar information for the same key intangibles would facilitate comparisons by users in respect of entities operating similar business models.

Location of direct information

- 4.14 Information on key intangibles would be presented either in the notes to the financial statements, or in a dedicated section in the management report.
- 4.15 By including the information in the management report, such information would not be subject to a full scope audit as required if it were included in the notes to the financial statements, but would be subject to the same level of independent assurance as other information contained therein. In addition, an IFRS requirement to present the information in the notes to the financial statements would make the requirement enforceable. The enforceability of a presentation in the management report would vary depending on whether or not it is also required by the relevant local applicable regulation; this would impact international comparability.
- 4.16 Other factors to be considered in deciding the location of the information include the management and forward-looking nature of the information, as opposed to accounting and retrospective.

Useful disclosures

- 4.17 Direct information on intangibles can be in the form of both qualitative and quantitative information.
- 4.18 Information is generally deemed more useful if it is linked with quantitative financial performance measures. However, for intangibles that have an indirect impact on performance, or are future oriented, it may be difficult, uncertain or commercially sensitive to provide information linking the resource to performance measures. Qualitative information is therefore important to supplement quantitative information and allow users a more complete understanding. There could also be situations where only qualitative information is available because the quantitative information is very preliminary or imprecise, especially in the early stages of new projects.
- 4.19 Ideally, quantitative aspects should complement qualitative disclosures as the existence of quantitative aspects alongside qualitative aspects allows users to have more information to assess the value of the company and its key intangibles.
- 4.20 Entities should, to the extent possible, provide an integration between qualitative information and quantitatively expressed information through key performance indicators. Disclosures should be provided over several periods, to enable users to compare entities over time and assess trends.

Elements of direct information

4.21 The tables below provide details on the information that could be provided for certain intangibles, when these are identified as key intangibles by an entity. The details provided below are by no means exhaustive and are provided only by way of illustration of possible direct information relating to intangibles.

| General information | |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Qualitative direct information | Quantitative direct information |
| Business model | |
| <ul style="list-style-type: none"> Information about the entity's business model and its value drivers. Information about organisational culture with relevance to specific key intangibles. Information about customer loyalty and trust. Information about related forward-looking tax planning activities. | <ul style="list-style-type: none"> Indicators that would help substantiate assertions in the qualitative information provided. |
| Information about specific key intangibles | |
| <ul style="list-style-type: none"> Information on whether the intangible would need to be replaced (e.g., software development) or updated (e.g. a customer database) or maintained (e.g. brand awareness). 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 is related to products or to customers. Information about legal and contractual rights associated with intangibles, including whether an intangible is (legally) owned by an entity. Information on benefits from specific intangible-related talent and expertise of employees. Information about the behaviour of providers of funding, collaborators or public authorities with relevance to a specific intangible. | <ul style="list-style-type: none"> Linkage with (elements of) intangibles recognised in the statement of financial position and profit or loss or cash-flows. Disclosure of standardised intangible-related metrics (e.g. license ratio by geographic area, number of product recalls), supplemented by entity-specific metrics (e.g. job leaving ratio, number of active patents). |
| <ul style="list-style-type: none"> Information on the remaining useful life of the intangible (if relevant). If the value of an intangible resource is provided (either in the notes or on the statement of financial position): information on the valuation method, including key assumptions used in the estimation and key inputs. | |

| Specific information for certain types of intangibles | |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Qualitative direct information | Quantitative direct information |
| Customer relationships (and similar) | |
| <ul style="list-style-type: none"> • Customer feedback. • Information on relationships with subscribers. | <ul style="list-style-type: none"> • Customer attrition. |
| Development costs (recognised on the statement of financial position) | |
| <ul style="list-style-type: none"> • Information on what is included in capitalised development costs. For example, it would be useful to present resulting patents, technologies or other intangibles separately, to allow comparability with information presented if the patent would have been acquired. | <ul style="list-style-type: none"> • R&D costs incurred (recognised in the profit and loss account) broken down by business type. • Ratio of R&D costs by total operating expenses and R&D costs by total sales. • Details on capitalised development costs including expected economic life. • Headcount related to R&D. |
| Intellectual rights/patents | |
| <ul style="list-style-type: none"> • Information on patent expiration. | <ul style="list-style-type: none"> • Number of patents with economically meaningful remaining terms. • Expected economic life of patents. |
| Internally developed products | |
| <ul style="list-style-type: none"> • Information on internally developed products: target population; countries in which it has been marketed/approved; selling price; competing products existing and under development); jurisdiction-specific opportunities or limitations; safety information (where applicable); market share and projections on market share; lifecycle plans, including prolongation; return on investment. | <ul style="list-style-type: none"> • Indicators that would help substantiate assertions in the qualitative information provided. |
| Information related to brands | |
| | <ul style="list-style-type: none"> • Disclosure on development in brand value, including the costs necessary to maintain the brand value. • Revenue related to each trade name. |

Non-financial information relating to specific intangibles

- 4.22 Financial information relating to specific intangibles can be complemented by non-financial qualitative and quantitative information (or ESG information), such as narrative explanations and metrics that would provide contextual information about the role and contribution of the specific intangible to the broader entity's value creation strategy.

- 4.23 The objective of this Discussion Paper is to focus on financial reporting and consider the financial aspects of value creation and the needs for the primary users of financial statements and management commentary. As a result, non-financial information is considered only to the extent that it is relevant to and can have an impact on the primary users. In this respect, non-financial information is only considered from a financial materiality (outside-in) perspective.
- 4.24 We note however that it is becoming more and more difficult to identify a clear dividing line between financial information and ESG information. This is because information needs of investors are evolving rapidly with the macrotrend of responsible and ESG investments. The growing attention to responsible investment has resulted in increasing demand by primary users of financial statements for more ESG disclosure, including better information about how an entity interacts with the external environment, the broader society and its labour force; and how this affects the creation and maintenance of its economic value, in particular in the long term, and its sustainability. The longer the investor's perspective, the more likely it is that some ESG risks and opportunities translate into financial impacts and, thus, more non-financial information is needed to make informed investment decisions. In addition, for responsible investors, their understanding the entity's strategy, processes and operations in dealing with ESG factors is an integral part of their financial decision to invest or divest.
- 4.25 The report *Embankment Project for Inclusive Capitalism (EPIC)* of the Coalition for Inclusive Capitalism notes 'In this 21st century business environment, intangible assets like human capital, organizational culture, customer loyalty and trust are more important than ever. They have become such important determinants of a business's success that, globally, intangible assets now represent on average over 50% of a company's market value – and up to 80% in some industries, such as advertising and technology. The problem is that standard accounting practices show the costs associated with these intangible assets, such as the cost of training employees or investing in innovation. But they still do not reflect the vast majority of their value.'
- 4.26 With the current economy focussing on services rather than manufacturing, tangible assets have become less important and have been surpassed by innovation, and other intellectual property as the most important value drivers: value creation is now driven by automation, superior technology as well as customer loyalty and human capital. Further evidence is that the ten largest companies by market capitalisation¹¹ include one oil company, a reinsurance conglomerate and a healthcare and consumer product conglomerate, with the remaining seven representing technology, internet platforms or internet-related offerings.
- 4.27 In the European Commission consultation for the revision of the EU Non-Financial Reporting Directive¹², it was noted that reporting on assets like companies' human capital or customer base may provide information very valuable to understand the companies' sustainability profile.

¹¹ <https://www.statista.com/statistics/263264/top-companies-in-the-world-by-market-capitalization/>

¹² <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Fina/public-consultation>.

Examples of disclosures on information relating to specific intangibles currently provided by listed companies

- 4.28 To the extent that the disclosures currently required by IFRS standards focus on intangible assets as defined by IAS 38, certain intangibles that either do not meet the definition of an asset or, while being assets, do not meet the criteria for recognition are not required to be disclosed. The only requirement related to unrecognised intangible assets is the requirement to disclose the aggregate amount of research and development expenditure recognised as an expense during the period.
- 4.29 To some companies this is insufficient to communicate their value creation potential. Therefore, they provide additional information, on a voluntary basis, on intangibles that are significant value creation sources. Accordingly, this Discussion Paper proposes to require the disclosure of information on the key (or core) intangibles, derived from the entity's business model. An example of how similar information is currently disclosed is provided below from the SAP 2020 Integrated Report¹³:

Figure 4.1 Extract SAP 2020 Integrated Report¹⁴

'The (intangible) resources that are the basis for our current as well as future success do not appear in the Consolidated Financial Statements. This is apparent from a comparison of the market capitalization of SAP SE (based on all issued shares), which was €131.7 billion at the end of 2020 (2019: €147.8 billion), with the book value of our equity in the Consolidated Financial Statements, which was €29.9 billion (2019: €30.8 billion)...The difference is mainly due to certain internally generated intangible resources that the applicable accounting standards do not allow to be recorded (at all or at fair value) in the Consolidated Financial Statements. These resources include customer capital (our customer base and customer relations); employees and their knowledge and skills; our ecosystem of partners; internally developed software; our ability to innovate; the brands we have built up, in particular, the SAP brand itself; and our organization.'

- 4.30 As indicated in the previous section, the proposed alternative to disclose direct information could be in the form of qualitative information or through quantitative information (or both complementing each other). An example of qualitative information on a drug that prevents some effects of COVID-19 can be found in the 2020 Annual Report of Merck Group.

¹³ As indicated in paragraph 2.5 the purpose of this discussion paper is not to consider how the book value of an entity should equal its market capitalisation.

¹⁴ For illustration purposes, we only include an extract of Financial Performance: Review and Analysis section of SAP 2020 Integrated Report. The complete section is included in the SAP 2020 Integrated Report, which is publicly available at SAP website.

Figure 4.2 Extract Merck Group 2020 Annual Report¹⁵

'In June, the U.S. Food and Drug Administration (FDA) cleared our investigational new drug application (IND) for M5049 for the potential treatment of patients with Covid-19 pneumonia. The first patient was dosed in the Phase II trial at end of July. M5049 is a potentially first-in-class small molecule that blocks the activation of Toll-like receptor (TLR)7 and TLR8, two innate immune sensors that detect single-stranded RNA from viruses such as SARS-CoV-2, the virus responsible for Covid-19. The aim of the study is to investigate if M5049 intervention at a critical point in the course of Covid-19 disease may prevent or ameliorate the hyperinflammatory response in patients with Covid-19 pneumonia and prevent progression to 'cytokine storm'. Successful intervention with the investigational drug may reduce life-threatening complications of Covid-19, including severe respiratory symptoms that often necessitate further medical interventions such as mechanical ventilation.'

- 4.31 As previously indicated, quantitative information can complement qualitative information. In this sense, although it is not always possible to provide both sorts of disclosure on key intangibles, the existence of quantitative aspects alongside qualitative aspects allows users of financial information to have more information to assess the value of the company and its key intangibles. An example of quantitative information complementing qualitative one on the customer satisfaction could be found in the SAP 2020 Integrated report.

Figure 4.3 Extract SAP 2020 Integrated Report - Customers¹⁶

'In early 2020, SAP brought together customer-facing teams into one organization known as Customer Success. This move enables customer-facing groups to work more closely in unison, providing the foundation for SAP to deliver on the value and experience customers require to be successful. Additionally, we have introduced our new operating model, which aligns sales, services, and customer engagement activities for a seamless experience across customer interactions. Over the next three years, we will roll out this operating model with the aim of improving customers' adoption and consumption of our solutions and ultimately their business outcomes...

SAP has implemented numerous global initiatives to ensure our focus on customers remains paramount. This includes improvements in the way we work with and care for our customers, taking measures to provide a consistent, end-to-end experience. Through a focus on empathy, we aim to be a company that listens and responds to its customers. We want customers to experience an SAP that is continuously improving. Through this approach, we aim to improve customer loyalty, as measured by the Customer Net Promoter Score (Customer NPS).

¹⁵ For illustration purposes, only the extract of Research and Development section of Merck Group 2020 Annual Report is included. The complete section is included in the Merck Group 2020 Annual Report, which is publicly available at Merck Group website.

¹⁶ For illustration purposes, only an extract of Customers section of SAP 2020 Integrated Report is included. The complete section is included in the SAP 2020 Integrated Report, which is publicly available at SAP website.

We use the Customer NPS as one feedback mechanism to measure customer loyalty. This allows us to directly understand what our customers are thinking and identify key pain points for action. Because of the importance of customers to SAP, Customer NPS is one of our main KPIs. In 2020, our Customer NPS increased 10 points year over year to 4 (2019: -6), strongly exceeding our target of -3 to -1. Using Qualtrics technology has enabled us to listen more closely to our customers and take action on the things that matter to them. We aim to continue to increase our Customer NPS to a range of 5 to 10 points in 2021. Further, we aim to increase the score steadily in the medium term. Beginning in 2020, Customer NPS has been included as a KPI in Executive Board remuneration as part of the short-term incentive component. For more information about executive compensation, see the Compensation Report section. For more information about the Customer NPS, see the Performance Management System section.'

Other initiatives

- 4.32 The disclosure of intangibles has been discussed by other initiatives such as that of the Korean Accounting Standards Board (KASB), the World Intellectual Capital Initiative (WICI) and the UK Financial Reporting Council (FRC).
- 4.33 A specific proposal for direct information on core intangibles has been put forward by the KASB. 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 information on the basis of preparation; main assumptions; key valuation inputs and assumptions.
- 4.34 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).
- 4.35 EFRAG has identified both positive and negative aspects of the proposal. The main concern is the relevance and reliability of the fair value information and the cost associated with measuring some unrecognised intangibles at fair value. It can also be questioned whether it is the objective of the financial statements to provide such forward-looking information as this could be in conflict with local regulations prohibiting the provision of such information or even triggering possible legal issues (e.g., if the intangible is finally sold to a materially different price).
- 4.36 However, although management's valuation of individual assets may not be information to be presented in the financial reports, the narrative information about both the value development/maintenance process and information about the model, assumptions and inputs could be valuable information for users to develop their own models.
- 4.37 In the alternative proposed above, disclosures of the fair value of intangibles are not proposed as the benefits to the primary users of the financial statements would not outweigh the costs that would be incurred. However, both the identification of key intangibles and the qualitative aspects whereby they add value were considered a positive aspect of the KASB initiative and have been considered in the alternative.

- 4.38 In 2019, staff of the UK Financial Reporting Council ('the FRC'), in the discussion paper 'Business Reporting of Intangibles: Realistic proposals' explores the reasons why intangibles cannot be fully reflected in financial statements without radical change and develops practical proposals for improvement in business reporting that can be expected to be implemented in the near future. This paper considers how financial statements might provide better information about expenditure on intangibles that are not recognised as assets and address the business reporting of intangibles outside of the financial statements, for example in narrative reporting. While disclosure of expenditure on intangibles relates to information for assessing how performance could be affected by changes in intangibles and is accordingly discussed in chapter 5, the narrative reporting section relates to direct information.
- 4.39 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.
- 4.40 The World Intellectual Capital/Assets initiative (WICI) has developed a principles-based framework which establish that organisations should, to the extent possible, provide an integration between narrative information and quantitatively expressed information through key performance indicators. According to WICI intangible reporting information should be based on the reporting frameworks principles of materiality, connectivity, conciseness, comparability and future-oriented. The WICI framework provides three levels of KPIs; general KPIs or those that may be relevant for most organisations across industries, industry-specific KPIs and organisation-specific KPIs.
- 4.41 Although the metrics or quantitative information complement the qualitative information, in this proposal it is considered, unlike the FRC staff's proposal and the World Intellectual Capital/Assets initiative (WICI) that there might be situations, as illustrated in Figure 4.1 above, where qualitative information provides relevant information on its own of potential value creation. In cases where the quantitative information is very preliminary or imprecise, especially in the early stage of new projects, the provision of qualitative information is useful for primary users of financial statements.
- 4.42 The review of the Management Commentary Practice Statement (MCPS) is expected to place greater emphasis on information about intangible resources. The IASB clarified that the MCPS will remain principles-based and will not provide detailed reporting requirements or suggest KPIs. Instead, it is expected that the MCPS will set as a principle, that when management identifies resources and relationships that the entity depends on for its long-term success, it would need to provide qualitative and quantitative information necessary for the primary users' understanding of the nature and importance of those resources and relationships (and their continued availability) to the future operation of the business. To support that principle, the MCPS is expected to provide high-level guidance for identifying the resources and relationships involved, but is not expected to provide an exhaustive list of such items nor a list of related disclosures, as these would be specific to entities and circumstances.

Identified advantages and disadvantages of information relating to specific intangibles

4.43 The table below includes some advantages and disadvantages of direct information compared with fair value recognition/disclosure and information for assessing how performance could be affected by changes in intangibles. Some advantages and disadvantages are developed further after the table.

Advantages of direct information

- It provides more granular and detailed information than information for assessing how performance could be affected by changes in intangibles and compared to disclosing the fair value of intangibles.
- Less subjective than disclosing the fair value intangibles (either for recognition or disclosure purposes).
- More useful to assessment stewardship than information for assessing how performance could be affected by changes in intangibles.
- Generally, it could be assumed to be less costly to provide than the fair value of intangibles (either for recognition or disclosure purposes).
- Could lead to less concern from preparers than providing the fair value of intangible resources. Providing such forward-looking information could be in conflict with local regulations or even give rise to possible legal issues (e.g., if the intangible is finally sold to a materially different price).

Disadvantages of direct information

- In some cases, it is difficult to determine the particular intangible the disclosures relate to (intangibles are interrelated).
- Identifying the key intangibles of an entity could be judgemental.
- Information could be commercially sensitive (affecting both the entity's competitive position and the risk of litigation).
- Depending on the KPIs, information could be more costly to prepare than information for assessing how performance could be affected by changes in intangibles.
- It would not provide a solution to the issue that acquired intangible assets are accounted for differently if they have been acquired versus if they have been internally generated.

Subjectivity

4.44 Some argue that users are not so much interested in the management's valuation of individual assets as they have their own models to assess the value of an entity as a whole. They consider that the entity's own valuation of the intangibles implies a high element of subjectivity and there might be bias toward management's over-optimism in evaluating the intangibles.

- 4.45 There is also a lack of measurement systems for most of the internally generated intangible assets, as well as value assessment methodologies to avoid overestimation or duplication in the valuation calculations. Internally generated intangibles recognised at fair value could result in abuse and make debt/equity ratios look better.

Granularity

- 4.46 Sufficient detailed and granular information related to the value of intangible assets enables primary users of financial statements to assess the value of intangibles using their own models. For example, to know how a marketing plan has been designed and implemented, when it did start, in which forms it was pursued, how many clients/households were involved etc. could help users to estimate the value of a customer list or a brand.
- 4.47 This provides more detailed information about an intangible than the valuation of the intangible itself, which is an ultimate outcome that users would not generally find very useful, due to the subjectivity. It also produces more in-depth information on intangibles than information for assessing how performance could be affected by changes in intangibles, which may provide valuable information on the income statement but serves to draw conclusions on the company as a whole rather than on individual intangible assets.

Stewardship

- 4.48 The disclose meaningful KPIs on key intangibles allows users to have more tools at their disposal to assess the performance of the management. For this to be effective, KPIs must be clearly defined and consistent over time.

Definitions and identifiability

- 4.49 Direct information requires specific intangibles to be identified and there is no common definition nor common understanding on the categories of internally generated intangible assets. As explained in Chapter 2, different terms are used for the same types of intangibles and some intangibles are overlapping (e.g., reputation versus brand value), which can make it complex to provide direct information on intangibles. In addition, certain KPIs are not necessarily related to a single intangible as they might affect the value of more than one intangible.

Cost

- 4.50 Providing direct information as that suggested in this chapter could generally be assumed to be less costly than the costs of recognising additional intangibles. It would be less costly than recognition as entities would not have to account for additional intangibles (including performing impairment tests or estimating fair value).
- 4.51 However, it would generally be more costly than providing information for assessing how performance could be affected by changes in intangibles as to provide direct information on intangibles entities would have to identify the various intangibles and prepare information for each of those. As discussed in chapter 5, to provide information for assessing how performance could be affected by changes in intangibles entities would need to provide information on specific income statement costs that would help users to assess which costs relate to the current year and which costs relate to future periods. Generally, financial figures are available within the company's books and the hardest aspect would be to determine which information is useful for users to make that distinction.

- 4.52 Some entities already provide information related to key specific intangibles in internal reports prepared for managerial purposes, which means that the cost of disclosing this information would be limited for these entities.

DRAFT

CHAPTER 5: INFORMATION FOR ASSESSING HOW PERFORMANCE COULD BE AFFECTED BY CHANGES IN INTANGIBLES

This chapter discusses the proposal to disclose information on intangibles indirectly, by communicating on the factors that affect the generation or maintenance of the intangibles of an entity. The underlying assumption is that users are not particularly interested in measures of 'the stock' of intangibles as they indirectly value these themselves based on the profitability/margins of the statement of financial performance and/or projected future cash flows. Relevant information is thus information to assess whether the current margins can be maintained, enhanced or will decrease in future periods. That is, information on factors that change the values of intangibles, rather than information on the value of intangibles. Changes in the values of intangibles can arise from the entity's investments and disinvestments in intangibles and from other factors. This chapter accordingly consider an approach under which an entity should provide information on:

- *Costs of a period that are not capitalised, but could be considered to relate to benefits that will be recorded in future periods. This chapter includes both proposals on how an entity can provide information to help users in their assessments of what costs relates to future periods and proposals on what information an entity can provide if the distinction of costs should be based on the management's assessments.*
- *Factors that could affect both recognised and unrecognised intangibles. This chapter proposes that sufficient information on these factors would generally be provided if entities disclose information on risk factors that are material and specific to the entity.*

Why consider information for assessing how performance could be affected by changes in intangibles?

- 5.1 Academic research indicates that professional investors consider the statement of financial performance to be more relevant for their decisions than the statement of financial position¹⁷. It could thus be argued that the most important information on intangibles is information that enables financial statement users 'getting the financial performance right' and provide information for predicting the future financial performance.
- 5.2 Arguably, an appropriate matching of income and expenses in the statement of financial performance and information, useful for predicting future financial performance, could be achieved by recognising intangibles in the statement of financial position and measure these in a manner that would result in a correct matching in the statement of financial performance (without elaborating in this paper on what that would mean). However, such an approach could have significant implications for the recognition and measurement of items in the statement of financial position, result in mismatching effects and it could be unjustifiable costly considering the benefits (including issues related to the faithful representation of the information) of the information and alternatives (see Chapter 3 above).

¹⁷ See the EFRAG/ICAS study Professional investors and the decision usefulness of financial reporting (2016), conducted by: Stefano Cascino, Mark Clatworthy, Beatriz García Osma, Joachim Gassen, Shahed Imam and Thomas Jeanjean.

5.3 An alternative to recognition could thus be to provide information that could help users of financial statements to assess the ‘correctly matched’ performance of an entity. Such information for assessing how performance could be affected by changes in intangibles could include information about the generation and maintenance (or changes) in intangibles without specifying the particular intangible to which the change is relate and factors affecting intangibles. The information could be useful for users of financial reports when analysing the entity’s financial performance and making predictions about future cash flows. The information could be provided as either complementary or alternative information to the direct information discussed in Chapter 4 or the recognition and measurement of intangibles discussed in Chapter 3.

What is information for assessing how performance could be affected by changes in intangibles?

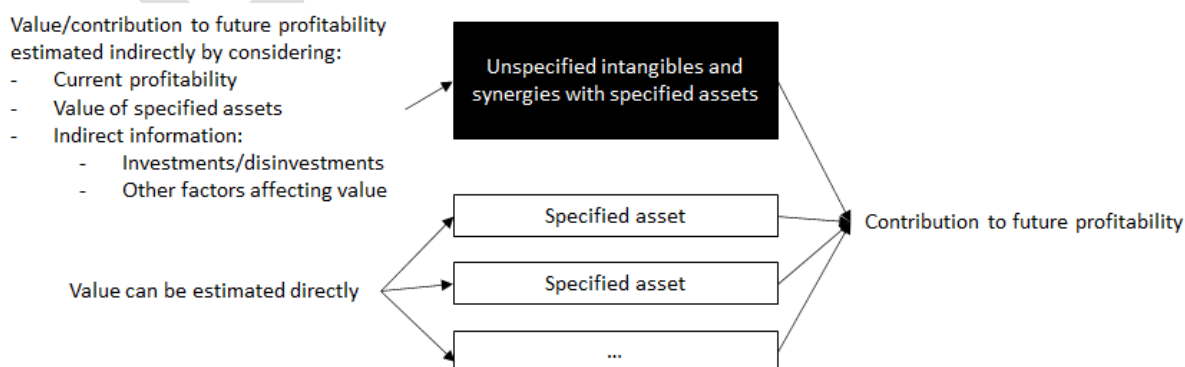
5.4 This paper uses the term ‘information for assessing how performance could be affected by changes in intangibles’ and ‘indirect information’ interchangeably to describe information useful for predicting any future change in profitability caused by changes in the contributions of intangibles (in combination with other assets). That is, ‘information for assessing how performance could be affected by changes in intangibles’ or ‘indirect information’ is information on factors that change the entity’s performance, rather than information on the value of specific intangibles. For example, although a company does not report its brand asset on its statement of financial position, earnings from the brand are reflected in its profitability. Thus, the firm is readily valued from its earning and information useful for estimating changes to the future earnings, rather than for estimating the value of the brand, could thus be sufficient.

5.5 Changes in future profitability related to intangibles can arise from:

- a) An entity’s investment or disinvestment (including inadequate maintenance) in intangibles;
- b) Other factors (affecting a single, several or all of the entity’s intangibles).

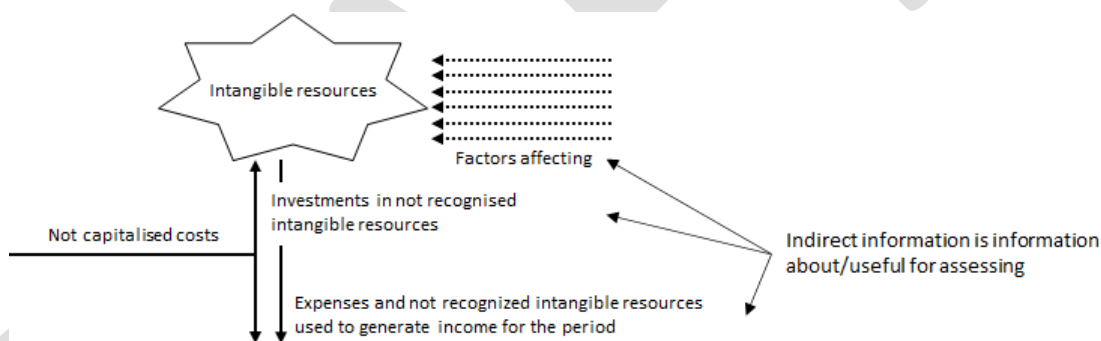
5.6 This is illustrated in Figure 5.1 below.

Figure 5.1 Illustration of information for assessing how performance could be affected by changes in intangibles (i.e. indirect information)



- 5.7 For example, if an entity reduces its marketing expenses related to a particular line of products, this may result in, among other things, a lower awareness of the entity's products (which could affect the value of an entity's brand and perhaps an entity's reputation) and hence lower revenue in the future. In this example, the change in the future profitability of an entity is accordingly related to the entity's 'investment' decision on intangibles ('investment' in scare quotes as the expenses used for the marketing would generally not be capitalised).
- 5.8 An example of other factors affecting the entity's future profitability could be a change in public focus on a particular issue. For example, if the public would be focused on what entities do to prevent money laundering, this could affect an entity's future revenue (through changes in intangibles such as reputation and brand) if the entity has either performed very well or very poorly on this area.
- 5.9 Information about an entity's investment or disinvestment in unspecified intangibles is provided by the costs spent on these. In practice, it could be difficult to separate information on other factors that affect unspecified intangibles from factors that also affect specified intangibles. Such a separation is accordingly not proposed in this Discussion Paper. This is illustrated in Figure 5.2.

Figure 5.2 Information for assessing how performance could be affected by changes in intangibles (Indirect information)



- 5.10 When considering whether information on specific intangibles would be relevant, the importance of that intangible for the value creation of the entity needs to be considered. As the intangibles to which indirect information is related may not be identified, such an approach would not work for indirect information. Instead, it could be assumed that the information would affect the decision of a financial statement user if earnings/the future cash flows or changes in earnings/future cash flows at entity level could be significant as a result of the (dis)investment or the factor.

Information for assessing how performance could be affected by changes in intangibles that could be useful

- 5.11 It follows from paragraph 5.5 and Figure 5.2 that information for assessing how performance could be affected by changes in intangibles be categorised into:
- Information on investments in unrecognised intangibles (versus costs used to generate income for the period (expenses of the period));
 - Information on the use of unrecognised intangibles;
 - Factors affecting intangibles.

- 5.12 These types of information are further explained and exemplified below. In the following paragraphs it is proposed that information on investments in unrecognised intangibles and information on the use of unrecognised intangibles is provided in the notes to the financial statements.
- 5.13 This Discussion Paper, however, does not include any suggestions on whether information on factors affecting intangibles should be included in the notes to the financial statements or in the management commentary.

Information on investments in unrecognised intangibles

- 5.14 For users of financial statements to be able to make projections on future profitability and cash-flows, it would be useful to have information on whether the costs of the period have been incurred to generate income in the period or in future periods.
- 5.15 There are two manners in which this information can be provided. Either:
- a) Entities can be asked to present separately in the notes to the financial statements expenses that accordingly to the management relate to the current period earnings and those incurred to generate earnings in future periods (alternatively this information can be provided on the face of the statement of financial position, see Chapter 3); or
 - b) Entities can be asked to provide information that would help users of financial reports to make a distinction between costs related to the current period earnings and future periods respectively.
- 5.16 Asking the entity to split the expenses has the potential to result in more accurate information due to the entity's access to detailed information. However, users may be critical about the information received from an entity as the information would always involve some level of subjectivity. Users may accordingly want to make their own split.
- 5.17 Should entities be required to do the split, guidance on which cost would relate to the future might need to be provided. This guidance could be based on what expenses would have been necessary in a no-growth scenario. The information provided by entities could split the costs per function and per nature as illustrated in Figure 5.3 and list the margins if no investments in growth were made.

Figure 5.3 Current/future nature/function matrix

| | Cost of sales | | Distribution and marketing costs | | Administrative expenses | | Total | |
|---------------------------------------------------------------|---------------|--------|----------------------------------|--------|-------------------------|--------|---------|--------|
| | Current | Future | Current | Future | Current | Future | Current | Future |
| Changes in inventories of finished goods and work in progress | | | | | | | | |
| Raw materials and consumables used | | | | | | | | |
| Employee benefits expense | | | | | | | | |
| Depreciation and amortisation expenses | | | | | | | | |
| Other expenses | | | | | | | | |
| ... | | | | | | | | |
| Total | | | | | | | | |

- 5.18 A presentation as that illustrated in Figure 5.3 may, however, not be the most suitable if many of the cells would be empty – for example because only some types of costs are related to a particular function. In that case lists could be more appropriate.

- 5.19 For users of financial statements to receive information on when the costs related to the future would benefit the entity, it could be useful to inform about the management's estimates on when the material costs are expected to result in benefits. It could thus be required that entities provide information about this in the notes to the financial statements. An example of how such disclosures could be provided in the financial statements is provided in Figure 5.4.

Figure 5.4 Example of disclosure on time range for benefits resulting from costs related to the future

Of 'Other expenses' that are 'Distribution and marketing costs', CU 1 234 relate to advertisement campaigns of the financial year CU 765 are considered to relate to the income of the current period, while CU 469 are expected to benefit mainly the following two financial year (primarily the following financial year).

- 5.20 If not providing the information directly, entities could help users of financial statements providing their own estimates of the cost of a period relating to the current period and those relating to future periods. For that purpose, a matrix that shows expenses by both function and nature could be useful to provide users of financial statements with information on types of expenses per function. The information could be provided in a manner similar to the matrix illustrated in Figure 4.2, however, without separate amounts for the costs related to the current period and to future periods. Again, if many of the cells would be empty, a list instead of a matrix could be a more appropriate manner of disclosing the information.
- 5.21 Although information on the types of non-capitalised costs that would be related to each function may help users making assumptions on the costs that relate to the current period and those relating to the future, more granular information will often be necessary for some types of costs. The entity could thus be required to provide information on specific costs (in addition to the current requirement in IAS 38 to disclose the aggregate amount of research and development expenditure recognised as an expense during the period), to the extent the costs would be material. The list of specific costs of the period could include, but not be limited to, for example:
- a) Spending on patents;
 - b) Marketing costs (including information on spending on trademarks/brands);
 - c) Staff training costs (not included in research and development costs or sales and marketing costs).
- 5.22 Figure 5.5 below shows a presentation of the distribution of research and development costs of a company.

Figure 5.5 Illustration on the distribution of research and development cost in a current financial report

Research and Development Costs

| € million | 2020 | 2019 | Change | |
|-----------------------|--------------|--------------|-----------|-------------|
| | | | € million | % |
| Healthcare | 1,640 | 1,666 | -26 | -1.5% |
| Life Science | 313 | 276 | 37 | 13.3% |
| Performance Materials | 274 | 267 | 6 | 2.4% |
| Corporate and Other | 62 | 59 | 3 | 4.3% |
| Total | 2,288 | 2,268 | 20 | 0.9% |

The ratio of research expenditure to Group sales was 13.0% (2019: 14.0%). The decline is due to the positive sales development.

From 2020 financial report of Merck Group.

5.23 Users seem to consider line items in the financial statements to be most useful when it provides information about the underlying business model and when they help forecast firm activities or evaluate managerial performance¹⁸. It may be reasonable to expect that the same would apply to financial information in the notes of the financial statements. It will follow below that information for assessing how performance could be affected by changes in intangibles may not be as useful as information on specific intangibles to understand the entity's business model and strategy. This is because information for assessing how performance could be affected by changes in intangibles does not directly identify the intangibles that are important for an entity. However, information on which areas an entity is using/spending its resources/costs could provide some information on its business model.

5.24 For this purpose, it could be considered to require information such as:

- a) Number of employees and employee costs per function, per segment and region (if segments are not based on regions);
- b) Marketing costs per market and brand (see also paragraph 5.21b).

Information on the use of unrecognised intangibles

5.25 For users of financial statements to project future cash flows, it is useful to know what happens when an intangible is used to generate income. Unlike (most) tangible resources, some intangibles may become more valuable and are hence able to generate more income in the future the more they are used. This could, for example, apply to some IT platforms that would increase in value the more content users put on them by users. On the other hand, similar to (most) tangible assets, some intangibles would need to be 'replaced' after some time which could involve significant costs (for example, intangibles resulting from a marketing campaign). Finally, while needing 'replacement' some intangibles are maintained 'automatically' through the operation of the business. This would, for example, normally be the case for a customer list.


¹⁸ Cascino, S. et al. 2021. The Usefulness of Financial Accounting Information: Evidence from the Field. The Accounting Review (forthcoming).

- 5.26 In Chapter 4, the information on specific intangibles proposed on whether an intangible is automatically replaced (or whether the intangible is related to products or customers) could be useful for distinguishing between intangibles that need replacement and intangible resources that do not, for example because they are automatically replaced. For intangibles that would require costly replacements, it could be useful for users of financial statements to receive information on the replacement period and cost of replacement for predicting future cash flows.
- 5.27 A possible useful information would be the disclosure of information on unrecognised intangibles used to generate income for the period. However, unless preparers of financial information would be required to provide information on (or at least keep track of) the cumulative amount of costs that relate to the future and are not capitalised, it would not be possible to provide exact information on unrecognised intangibles used to generate income for the period.
- 5.28 To some extent, however, users might be able to work around that for the prediction of future cash flows if they, based on the information on what cost of a year relates to 'investments' would be able to assess steady-state margins and would then be able to predict how the future would deviate from a steady-state. This prediction could be based on whether 'investments' increase or decrease.

Factors affecting intangibles

- 5.29 A list of factors that could affect an entity's intangibles could be very long. Although this Discussion Paper only focuses on information that is useful for the primary users of financial reports, issues that might currently only be considered useful for assessing the entity's policies in an area could end up having a significant impact on e.g., the entity's brands. An example was provided in paragraph 5.8 above.
- 5.30 Requiring entities to provide long lists of possible factors that could affect its intangibles might not be realistic or cost/benefit effective. Similarly requiring all types of, for example, ESG information in financial reports could make the financial reports less accessible for their primary users.
- 5.31 This Discussion Paper accordingly proposes a requirement to disclose risk factors that are material and specific to the entity – i.e., risk 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, relevant measures reflecting the risk if relevant (e.g., KPI's used to measure it) and how the risk is managed and mitigated. The factors should be limited to those that are material for the primary users of financial statements. It should include an assessment of the materiality of the risk factors based on the probability of their occurrence and the expected magnitude of their negative impact. Each risk factor should be described, explaining how it affects the entity. This approach would also require the entity to describe its business model (see Chapter 4).
- 5.32 In some jurisdictions, entities are already required (either in the financial statements or in e.g., listing documents) to disclose similar information for risks in general or for specific types of risks (e.g., related to environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters). Figure 4.4 provides an example of how such information is currently provided.

Figure 4.4 Illustration on how information on risks related to intangibles is currently provided

| Performance | Associated KPIs | Associated risks | |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>...</p> <p>We have continued to reallocate investment towards our best opportunities for future growth and increased profitability, which has driven a 17% increase in R&D and S&M expenditure on products categorised as "Invest".</p> | <ul style="list-style-type: none"> - Research and development reallocation - Sales and marketing reallocation | <ul style="list-style-type: none"> - Inability to attract skills and resources - Poor resource allocation - Inadequate processes and systems | |
| Identify | Evaluate | Analyse | Mitigate |
| <p>Operational risks</p> <p>...</p> <p>Skills and resources</p> <p>We do not have or cannot attract and retain the required skills and resources for strategic and business delivery</p> |  | <ul style="list-style-type: none"> - Potential to create key person dependencies - Capacity issues and inability to focus sufficient management attention where required - Inability to execute strategy and achieve business deliverables | <ul style="list-style-type: none"> - Talent management, skills attraction and recruitment processes in place - Resource allocation processes in place |

Extracts from the Sage 2014 annual report.

- 5.33 Users may also consider general market information (e.g., market growth and price development) to be useful. For example, if the market is growing this could increase the value of an entity's brand. However, as general market information could be retrieved by users from other sources, this Discussion Paper does not propose to introduce requirements for companies to disclose such information.

Initiatives considering information for assessing how performance could be affected by changes in intangibles

- 5.34 The idea that some cost of a period is an investment for future periods (which could be both successful and unsuccessful) and that information about this could be useful, is not new. In its 2001 proposal for a new agenda project 'Disclosure of Information about Intangible Assets not Recognised in Financial Statements', the FASB, for example, noted that information to be provided on intangible assets (not recognised) could involve 'expenditures to develop and maintain them'.
- 5.35 Academic research has, similarly, examined, for example, whether investments in intangibles, that are included in operating expenses should be measured and separated from operating expenses¹⁹.
- 5.36 In 2019, staff of the UK Financial Reporting Council ('the FRC'), in the discussion paper *Business Reporting of Intangibles: Realistic proposals* proposed specific disclosure requirements of the amount and nature of investments in unrecognised intangibles that are treated as an expense in the period, particularly those that are incurred with a view to generating benefit in subsequent accounting periods ('future-oriented intangibles'). These should be clearly differentiated from expenses that unambiguously relate to the period. However, the proposal went further than what is suggested in this chapter, as it also suggested that the cumulative amount of future-oriented expenditure that is expected to benefit future periods, and movements in it, should be disclosed.

¹⁹ See, for example: Kanodia, C, Sapra, H., Venugopalan, R. (2004). Should intangibles be measured: what are the economic tradeoffs? *Journal of Accounting Research*. 42: 89–120 and Enache, Luminita; Srivastava, Anup. (2018) Should Intangible Investments Be Reported Separately or Commingled with Operating Expenses? *New Evidence. Management Science*. 64 Issue 7, 3446-3468.

- 5.37 The proposals of the FRC staff were based on the approach that the entity should determine by itself which costs relate to future periods.
- 5.38 The views of respondents commenting on the proposals were divided. The main concern of those who did not support the proposals was the inherently subjective nature of the allocation of costs between current period expenses and expenditure on future-oriented intangibles. Many respondents believed that this could not be done in a consistent and non-arbitrary manner. There were also concerns that it would be open to manipulation by management, with a view to presenting a more favourable view of current period earnings.
- 5.39 As noted above this chapter presents an alternative to having the management splitting costs between current period expenses and costs related to 'investments'.
- 5.40 As mentioned in paragraph 5.32 information about certain risks are already required in many jurisdictions. Examples of EU legislation include: Regulation (EU) 2017/1129 (on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market) and the related Delegated Regulation (EU) 2019/980.

Identified advantages and disadvantages of information for assessing how performance could be affected by changes in intangibles

- 5.41 The table below includes some advantages and disadvantages of information for assessing how performance could be affected by changes in intangibles compared with information on specific intangibles and recognition/measurement of intangibles. The advantages and disadvantages are considered further after the table.

Advantages of information for assessing how performance could be affected by changes in intangibles

- A fixed terminology to be used to distinguish between different intangibles is not necessary for providing information for assessing how performance could be affected by changes in intangibles.
- As the approach is based on the combined effect on earnings at entity level, it can take into account that intangibles often do not create much value on a stand-alone basis but together with other intangibles or other assets. It is thus not a problem when providing the information that intangibles are interrelated.
- Does not require specific intangibles to be identified and measured. Issues with measurement of intangibles would be avoided.
- Generally, it could be assumed to be less costly to provide than recognising intangibles or providing information on specific intangibles.

Disadvantages of information for assessing how performance could be affected by changes in intangibles

- Users would not receive information on specific key intangibles for the entity's business model.
- Effectiveness of investments in intangibles is not taken into account.

-
- Difficult to 'match' revenue with costs of previous investments.
 - Less useful for assessment of stewardship.
 - Less granular information on intangibles compared with direct information and recognition.
 - Would require guidance on what different types of costs should include.
 - To the extent the entity is splitting costs related to the current period and to future periods (see paragraph 5.15), the information will be quite subjective. If, instead, information is provided to help users perform their own split, the information will be less subjective.
 - It would not provide a solution to the issue that acquired intangible assets are accounted for differently if they have been acquired versus if they have been internally generated.
-

Identifying intangibles

- 5.42 Information for assessing how performance could be affected by changes in intangibles does not require specific intangibles to be identified. As explained in Chapter 2, different terms are used for the same types of intangibles and some intangibles are overlapping (e.g., reputation versus brand value), which can make it complex to provide information on specific intangibles.
- 5.43 On the other hand, information for assessing how performance could be affected by changes in intangibles would require more guidance on how to classify different types of costs in order for the information to be comparable and reduce the possibility of the different cost categories to be used opportunistically by management (for example, guidance should be provided on what should be included in research costs, in marketing costs, in costs on patents and in staff training costs).
- 5.44 Also, when intangibles are not identified, it may be more difficult for users of financial statements to understand the specific intangibles that are vital for the entity and the entity's business model.
- 5.45 Only providing information on (or to help the users assess) costs related to future periods (i.e. 'investments'), does not inform on how well these investments perform. For example, an entity can spend a lot of money on training staff in a new computer system which is then scrapped before it is taken into use, this failed investment will not appear directly from the financial statements (e.g., in the form of an impairment loss). Similarly, it can be that an entity is decreasing its marketing expenses, but if the money is just spent more wisely, this decrease may not mean that the intangibles related to customer's perception and knowledge of a product/entity would decrease. Qualitative information related to the cost, for example, explanations of changes compared with last year may help users understand the management's intentions and expectations related to the changes. However, it may not be possible subsequently to check whether the management's expectations were realised. Information for assessing how performance could be affected by changes in intangibles may accordingly not be as good as information on specific intangibles for assessing the management's stewardship.

Measurement of intangibles

- 5.46 As information for assessing how performance could be affected by changes in intangibles does not include measurement of intangibles at either cost or fair value, the issues related to the uncertainty of such measurement could be avoided.

Use of investments

- 5.47 As previously noted, and unlike other proposals²⁰, this chapter does not propose that preparers would be required to register and keep track of the cumulative amount of not capitalised costs that relate to 'investments'. The input on which this discussion paper is built, did not identify as a user need information on the cumulative amounts of not capitalised costs related to future earnings. This also means that users of financial statements will not be able to receive information on when the 'investments' are used and hence determine the 'correct' margins by matching the income of a period with the related expenses.
- 5.48 To the extent that the management provides an assessment of the costs that relate to future periods, the suggested disclosures on when the costs are expected to result in benefits could be used to estimate this. However, this would require users to keep records of the 'investments' of previous periods and when the benefits of these were expected to incur. This may be less of an issue as financial information is digitalised. Users would, nevertheless, not receive information in advance if the 'investment' is no longer expected to result in benefits or if the time period for the benefits has changed.

Costs of preparing the information

- 5.49 Providing information for assessing how performance could be affected by changes in intangibles as that suggested in this chapter could generally be assumed to be less costly than the costs of recognising additional intangibles or providing information on specific intangibles. It would be less costly than recognition as entities would not have to account for additional intangibles (including performing impairment tests or estimating fair value). It would be less costly than information on specific intangibles, as entities would not have to identify the various intangibles and prepare information for each of those. Information for assessing how performance could be affected by changes in intangibles, as considered in this Discussion Paper, would imply that additional information is provided about the changes of intangibles in a period. This means that, for example, that additional information would not have to be stored from one accounting period to another.
- 5.50 To the extent that information for assessing how performance could be affected by changes in intangibles is used to supplement information on specific intangibles, the cost-saving benefits of information for assessing how performance could be affected by changes in intangibles would, however, diminish or disappear completely.

²⁰ For example, the proposal of the FRC staff mentioned in paragraph 5.36.

CHAPTER 6: WAY FORWARD AND CHALLENGES AND ISSUES FOR POSSIBLE SOLUTIONS

When considering how to provide better information on intangibles, it should also be considered:

- *Whether it would be beneficial to establish a common terminology on intangibles;*
- *How to provide useful information but at the same time not require entities to disclose information that is very commercially sensitive;*
- *Where the information should be provided –in the financial statements (including the notes), in the management commentary, or somewhere else);*
- *Whether it is possible to audit the information and at a cost that would not outweigh the benefits of having the information audited;*
- *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.*

Which way forward?

- 6.1 This Discussion Paper has identified different approaches for better information on intangibles. It could thus be considered that better information on intangibles could be achieved by:
- a) Amending recognition and measurement requirements for intangibles (Chapter 3 provided different manners in which this could be done);
 - b) Providing information on specific intangibles (Chapter 4 provided examples of information on specific intangibles that could be useful);
 - c) Providing information for assessing how performance could be affected by changes in intangibles (Chapter 5 discussed different approaches for this and provided examples of information that could be useful).
- 6.2 For each of these approaches, information on factors affecting intangibles would be useful.
- 6.3 Some of the approaches could be combined or different approaches could be used for different types of intangibles (e.g., one approach could be used for intangibles that meet the definition of an asset and another approach could be used for intangibles that would not meet the definition of an asset). The approaches mentioned in a) and b) in paragraph 6.1 could thus be combined. Approach c) could in principle also be combined with Approach b), however, many of the (cost) advantages of providing information for assessing how performance could be affected by changes in intangibles would then disappear.

Some additional factors to consider

When considering possible solutions for better information on intangibles, there are some other factors to consider. The previous chapters have already mentioned some of the following factors. Terminology

- 6.4 There is no fixed terminology when it comes to describing intangibles. Different words can accordingly be used for the same intangible, and the boundaries of what is included in a particular term can differ. The introduction of a common terminology could therefore be considered as something that could be useful for the reporting of intangibles. If information on intangibles would be based on information for assessing how performance could be affected by changes in intangibles (see Chapter 5), a common terminology on intangibles might be less necessary than if information on specific intangibles would be provided or if more intangibles would be recognised in the financial statements. However, in that case, it may be beneficial to provide more guidance on how to classify different types of costs.
- 6.5 The introduction of a common terminology might also clarify how different intangibles may be overlapping.

Sensitiveness of the information provided

- 6.6 Another factor that was mentioned above, although only shortly, was that some of the information proposed could result in entities having to disclose information they consider commercially sensitive. Although the threshold should be high, it would be necessary to allow entities not to present certain information if it would be highly commercially sensitive. When this would be the case, it should be considered whether alternative information could be presented (a type of 'comply or disclose alternative information' approach).

Placement of information

- 6.7 This discussion paper only considers information that could be presented in the financial statements, the notes to the financial statements and the management commentary. The discussions about information on specific intangibles and information for assessing how performance could be affected by changes in intangibles in Chapter 4 and Chapter 5 do generally not consider what information would be best placed in the notes to the financial statements and what information would be better placed in the management commentary. Similarly, the discussion paper does consider whether some of the proposed information might be better provided outside of the financial reports. Currently some preparers communicate additional information on intangibles that is useful for the primary users of financial statements outside financial reports. This, for example, happens when it would be very costly/not possible to have the same type of internal scrutiny and control of the information as is applied for the information provided in the financial reports. Besides discussing what information to be provided, it could be relevant also to discuss where the information should be provided.

Auditability and audit costs

- 6.8 The previous chapters considered the issues that could be related to prepare the information and the costs of preparing the information. In addition to this, it should be considered whether it would be possible to audit the information (including how subjective the information will be) and whether the benefits 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 include some information that would free them from finding the information in other sources, but may not attach a high value to the fact that some pieces of information are not audited.

Potential effects on the ability to receive finance

- 6.9 To the extent that it could impact an entity's ability to receive finance that information is presented in a particular manner, this should be taken into account. For example, when considering what assets should be recognised in the statement of financial position (including which assets should be recognised separately from goodwill), it should be taken into account if recognising these assets 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)²¹.

Removal of some of the current requirements

- 6.10 The previous chapters have mainly considered how additional information can be provided on intangibles. However, when addressing how to provide better information on intangibles (because better is not the same as 'more'), it would also be appropriate to assess whether some of the current requirements, for example those related to how to account for intangibles acquired in a business combination, which can be costly for preparers to comply with, could be removed/amended without reducing the usefulness of the information provided to users.

²¹ See, for example, Anna Thum-Thysen, Peter Voigt *Unlocking Investment in Intangible Assets* (2017).

APPENDIX 1: BIBLIOGRAPHY

TO BE INCLUDED

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APPENDIX 2: ACKNOWLEDGMENTS

This Discussion Paper was prepared jointly by the staffs of the European Financial Reporting Advisory Group (EFRAG), [Other National Standard Setters] as part of Europe's proactive work in financial reporting.

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