Think Ahead ACCA

Better information on intangibles: which is the best way to go?

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Comments from ACCA
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GENERAL COMMENTS

ACCA welcomes the opportunity to provide views in response to EFRAG's discussion paper considering different ways in which the reporting of intangibles could be improved. This was done with the assistance of ACCA's Global Forum for Corporate Reporting.

The issue of reporting on intangibles is in our view a key matter that needs to be addressed and are pleased to note IASB's adoption of a research project and EFRAG's work on the issue. Studies have shown the increasing gap between the market value of companies and their net asset value. While it should not be an objective of financial statements to support and justify market values, the scale of the gap does raise questions as to whether financial statements adequately recognise as assets the intangibles that are increasingly the drivers of value in businesses. In addition to this asset issue, the reporting of those drivers of value could be improved. ACCA has published three reports on the current position covering both of these issues. We are preparing a fourth report in this series to look at why so few companies report at all on R&D which is a key intangible in this regard.

We very much support EFRAG's proposed three-line approach combining

- increased asset recognition
- information about specific key intangibles and
- identifying current expenditure expected to give future benefits.

We note that all of these may require significant judgement from management, but especially the third.

Increased intangible asset recognition should be based on the comparable criteria and accounting for tangible assets and in most cases on an amortised cost basis. We do not support using a fair value model for intangible assets that will generate value as part of a business.

RESPONSES TO SPECIFIC QUESTIONS RAISED

QUESTION 1 - ISSUES WITH THE CURRENT INFORMATION

Chapter 2 summarises issues put forward with the current information on intangibles. Do you think the issues listed are relevant and valid? Are there additional issues with the current information on intangibles that are not listed? If so what are these issues?

The issues raised with the current reporting of intangibles in Chapter 1 are all relevant and valid.

ACCA has published a series of research reports into the current reporting of certain intangibles – research and development (R&D), software and exploration and evaluation costs of extractive companies. References and links to those are provided at the end of this response.

These certainly report relatively low levels of disclosures which is an issue noted in Chapter 1.

Other findings have included that

- The great majority of listed companies neither report an asset of development expenditure nor an expense for R&D despite the definition of development expenditure being drawn very widely by IAS38. This implies either widespread low levels of investment in developing new products and processes or that financial reporting is seriously understating such corporate investment by treating them as other expenses.

- Low levels of capitalisation of R&D which might reinforce the impression that capitalisation is a matter of accounting policy choice for management

- In contrast to the low frequency of capitalisation of development costs, a much larger proportion of firms capitalise software development costs, even though the amounts involved can be considered immaterial relative to companies' total assets and/or market values. This suggests that it is unlikely that materiality is an issue for not capitalising or expensing separately R&D expenditure.

- Strong national variations in the extent to which financial statements report software development costs

- In the extractive industries the basic model of capitalisation and impairment of exploration and evaluation costs is applied by most companies in one form or another and seems to be working. This contrasts with the relative lack of capitalisation of the development costs of new products and processes under IAS38.

All of these point to problems with the information about intangibles coming from

- the way IAS 38 articulates the criteria for capitalisation of internally generated development costs, as well as

- a failure to apply the existing requirements properly.

These two factors need to be borne in mind when considering changes to the standards.

SIC32 needs also to be considered. Limiting capitalisation of website development costs to those websites that directly raise revenue seems to be overly restrictive and does not recognise their role in developing brand and product awareness.

QUESTION 2 - WHICH WAY TO GO?

Chapters 3, 4 and 5 present possible different approaches to provide better information on intangibles (namely recognition and measurement; disclosure of information on specific intangibles; information on future-oriented expenses and risk/opportunity factors) and, within each approach, different alternatives to provide better information on intangibles.

These different approaches represent different trade-offs between benefits and costs when considering the different needs of users of financial reports for better information on intangibles.

Do you think there is room for improvement regarding information on intangibles in financial reporting? If so:

a) Do you think the different approaches described could be combined in a manner that could meet (most of) the needs of users and for which the benefits would exceed the costs? If so, please describe such a combination.

b) If you do not think the different approaches described in the Discussion Paper could be combined in a manner that would meet (most of) the needs of users, which (if any) of the described approaches do you think could be worth investigating further with the objective of getting better information on intangibles:

- *Amending existing recognition and measurement requirements for intangibles (see Chapter 3);*
- *Providing disclosures on specific intangibles (see Chapter 4);*
- *Providing disclosures on future-oriented expenses and risk/opportunity factors that may affect future performance (see Chapter 5); or*
- *An approach other than those described in the Discussion Paper (please explain this approach)?*

A combination of the approaches would seem best. Though all three may be relevant in many cases, intangibles as noted cover a great range and not all will be appropriate in each case. For example marketing may not be key for the business model and so only consideration of recognition or disclosure as forward oriented information may be appropriate. Workforce development may not be eligible for recognition as an asset and so only the other two may be possible.

It would be a helpful further step for EFRAG to start exploring the application of the different approaches to different categories within the range of intangibles in order to move towards the best approach.

QUESTION 3 - RECOGNITION

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 Intangible Assets should be amended to permit the recognition of certain internally generated intangible assets (in addition to development costs)? (Please explain your answer). If your answer to this question is 'yes', please also answer sub-questions 1 to 3 below.

Yes we agree that IAS38 should be amended to widen the scope of intangible assets that should be recognised and also to change the articulation of the requirements to reduce the discouragement to recognition. Currently the financial statements most often have no reference to intangibles such as R&D and of those few that do the majority expense all costs as incurred.

Other IFRS requirements dealing with intangibles such as IFRS6 and SIC 32 should be included in a review.

1. Paragraph 3.26 of this Discussion Paper explains that IAS 38 currently includes an explicit prohibition to recognise some types of internally generated intangible assets such as internally developed brands, mastheads, publishing titles, customer lists and similar items, staff training and marketing. Do you consider that the explicit prohibition to recognise some types of intangible assets that exists in IAS 38 should be removed? (Please explain your answer).

We agree that the explicit prohibitions in IAS38.63 and 64 should be removed. There should be a new recognition model based on the definition of an asset in the Conceptual Framework as a starting point This would reduce the current differences between acquired and internally generated intangibles and also those between tangible and intangible assets.

2. Paragraphs 3.10 to 3.71 of this Discussion Paper explore four possible approaches regarding the recognition of internally generated intangibles. Which of the following approaches would you support?

a) Recognise (as an asset) all defined intangibles; with no specified conditions or thresholds (see paragraphs 3.15 - 3.35 of this Discussion Paper);

b) Threshold for recognition of an asset (see paragraphs 3.36 - 3.48 of this Discussion Paper);
c) Conditional recognition of an asset (see paragraphs 3.49 - 3.59 of this Discussion Paper); if you prefer this approach, would you prefer an approach under which:
(i) Costs are expensed in profit and loss until the condition is met;
(ii) Costs are capitalised and fully impaired until the condition is met, at which point in time the impairment losses are reversed;
(iii) Costs are expensed in other comprehensive income until the condition is met, at which point in time the expenses are 'recycled' and capitalised.
d) No recognition (that is, expensing all internally generated intangibles) (see paragraphs 3.60 - 3.67 of this Discussion Paper); and
e) None of the above or other suggestions (please explain).
Please explain the reasons for your preferences.

In line with the findings from our report on the accounting treatment of R&D expenditures, based on responses from preparers, auditors and users, we support the conditional recognition approach for intangibles in c) which would better align internally generated intangible assets with tangible than a) or b).

Where the recognition threshold is reached then the full cost of the asset should be recognised, as proposed in (ii) above. Part of the current absence of intangible assets under IAS38 can be attributed to its following an approach like (i) which allows for development costs to be expensed right up until the launch of a product on the grounds of commercial uncertainty. We would not support further items (such as these development costs under (iii) above) being recognised in OCI, as there is no consistent basis for determining what is treated as OCI.

Immediate write-off of all expenditure on intangibles (as in d) above) would exacerbate the current situation with financial reporting understating the investment being made and failing to distinguish successful new products/processes from the unsuccessful. There is evidence that investors do not want such an approach (see our report on R&D as well as Mazzi, Slack, Tsalavoutas and Tsoligkas 2022).

3 If you support 'Conditional recognition of an asset' or 'Threshold for recognition of an asset' in the previous sub-question, which criteria would you consider for recognition:
a) Criteria based on the level of (un)certainty about the outcome of the intangibles (that is, the 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 a legal right and/or the ability to sell, transfer, licence or pledge the asset;

(e)All or a combination of the above depending on the nature of the intangibles (please explain);
(f) Other suggestions (please specify).

There may be elements needed of all of the criteria noted above.

The intangible would have to meet the definition of an asset meaning tests of control of a legal right and one that has the potential to produce economic benefits. The main recognition criteria beyond those should be around the probability of the economic benefits.

Any new model will also need to address the issue that intangible assets need to be identifiable. Internal projects in many cases, may not at the beginning aim to create an intangible – for example they may be more focused on brand awareness etc – but in the end create one. Defining exactly what is an identifiable intangible may well be a challenge.

Defining the unit of account will be necessary for the conditional recognition approach.

Recognition criteria should be assessed for the range of potential intangible assets as noted under Q2 above.

QUESTION 4 - POSSIBLE MEASUREMENT BASES

Paragraphs 3.72 to 3.100 of this Discussion Paper consider possible measurement bases for internally generated intangibles without suggesting a preferred approach. If you think that IAS 38 should be amended to permit the recognition of certain internally generated intangible assets (in addition to development costs), which of the following suggested measurement approaches 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')?

The model in most instances should be that of cost with amortisation and impairment.

However, there are intangibles where approach d) the IFRS3 model may be more appropriate – for example where the costs are difficult to identify, acquired in a business combination (as at present), acquired for no consideration or perhaps on the initial application of any new standard. Market transactions from which to derive the fair values in these cases may be difficult to find. It may be that another current value measure such as value in use may be a more relevant and feasible measure.

IAS 38 currently allows in limited circumstances the revaluation model. It adds complexity to the standard but does provide a comparable approach to IAS16 which is helpful. While we do not think it is used often there are some cases where reliable fair values may be able to be applied and so this might remain as an option. More research into the current use of the option would be helpful in deciding on its retention.

We would not support the fair value model, except if there were intangible assets held as investments or for trading and there were active markets in them. For the majority of cases however the fair value model adds complexity and introduces uncertainty and reduced verifiability into the performance statement as so few intangibles have reliable fair values.

QUESTION 5 - INFORMATION RELATING TO SPECIFIC INTANGIBLES

Chapter 4 discusses an approach under which information on specific intangibles, that are key to an entity's business model, is provided to help users assess the contribution of the intangible to the value of the entity.

1 To the extent that information relating to specific intangibles should be provided, do you agree that the information should be limited to the intangibles that are key to an entity's business model? If not, why?

2 Preliminary feedback received from some users of financial reports indicates that an entity's fair value estimate of a specific intangible would generally not be particularly relevant information. Do you agree that disclosing the fair value of an intangible is less helpful for users than disclosure of quantitative and qualitative information that could assist them in forming their own views on the value for an entity of the specific intangible?

3 Do you agree with the advantages and disadvantages of information relating to specific intangibles as identified in Chapter 4 compared to recognition and measurement (see Chapter 3) and information on future-oriented expenses (see Chapter 5)? If not, which aspects do you disagree with and/or which additional advantages and disadvantages have you identified?

We support the idea that the further information about specific intangibles should be limited to those that are key for the entity's business model. The selection of those intangibles is going to be a matter of judgement and not easily prescribed. We are also aware that ESRS may require information about intangibles to be disclosed and given the double materiality concept underlying those standards their requirements may extend beyond key intangibles.

We agree that many users may be more interested in information that may help them assess the value of the entity as a whole rather than individual assets. The sort of information proposed about key specific intangibles may help them do that. Reliable fair values of individual intangibles may be difficult to come by as noted above. For some intangibles that may be less of a problem and in those cases fair values of specific intangibles could be helpfully disclosed, even just as a comparison for those users who will make their own value assessments.

In terms of the advantages and disadvantages, the comparison with recognition and with future-oriented expense disclosure seem odd when the premise of the paper seems to advocate a combination of approaches.

QUESTION 6 - INFORMATION ON FUTURE-ORIENTED EXPENSES

Chapter 5 proposes various elements of information on expenses recognised in a period that could be considered to relate to benefits that will be recorded in future periods ('future-oriented expenses').

1 Do you consider that requiring such information could be useful? If so:

a) Should the information mainly complement information on specific intangibles (see Chapter 4) or should requirements on future-oriented expenses be introduced instead of requirements on information on specific intangibles?

b) Should the information mainly:

(i) Reflect the views of the entity's management by disclosing the recognised expenses the management considers relate to the benefits of future periods)? Or

(ii) Help users perform their own assessments on the recognised expenses that relate to benefits of future periods, by providing further specifications and breakdown of the expenses of a period?

2 Do you agree with the advantages and disadvantages of information on future-oriented expenses identified in Chapter 5? If not, which aspects do you disagree with and/or which additional advantages and disadvantages have you identified?

We agree that the disclosure of future-oriented expenses separate from current period expenses would in principle be helpful in combination with other information about intangibles. We foresee that the identification of such expenses would be very judgemental. Definitions and supporting guidance will be difficult to draw up to ensure reasonable comparability and faithful representation.

Such disclosures should complement that on specific intangibles and any such expense on specific intangibles would need to be excluded or separately identified.

The identification of future-oriented expenses will be judgemental and will inevitably, and should, reflect the view of management. It is difficult to see how users can identify such expenses even from a further analysis of costs. For example marketing expenses may relate to the current year or to future ones, simply providing users with the total marketing expenses is not going to allow that split to be made. We do not find that Figure 5.2 points to a very helpful approach.

QUESTION 7 - INFORMATION ON RISK/OPPORTUNITY FACTORS AFFECTING INTANGIBLES

Chapter 5 proposes that information included in the financial reports on factors affecting intangibles should be limited to disclosing risk/opportunity factors linked to the key intangibles (whether or not specified) according to the entity's business model. The disclosure should include a description of the risk/opportunity, relevant measures reflecting the risk/opportunity, if relevant (for example, KPI's used to measure it), and how the risk is managed and mitigated. It should include an assessment of the materiality of the risk/opportunity factors based on the probability of their occurrence and the expected magnitude of their impact.
Do you agree with this proposal? If not, what information on risk/opportunity factors affecting intangibles should be provided?

We agree that this information about key intangibles would be useful.

QUESTION 8 - 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?

It would be helpful to introduce a common terminology. This should aid the analysis of the different approaches that may be required by different categories of intangibles and also help change the perceptions about R&D and what should be thought of as included as intangibles.

We agree there would need to be some exclusion for very commercially sensitive information. We would expect this would be restricted to the information about specific intangibles (including the risks and opportunities they present) and would not be needed in relation to recognition and measurement disclosures or to future-oriented expenses.

We have noted in response to Q1 that there are issues in relation to the low levels of identification of R&D expenditure and capitalisation of development costs which should be investigated and addressed.

Any project on intangibles has to decide on the scope and in particular whether the exploration and evaluation costs of extractive activities will be covered or not. In our view these are intangibles and are very comparable to other ones. An IASB project should result in coherent accounting for intangibles in general.

Any significant alterations to recognition and measurement of internally generated intangibles and the disclosure of future-oriented expenses would represent major changes. As noted in this paper many current accounting systems may fail to capture the costs of their development and so this might entail information system amendments requiring time and costs. As with any major accounting change there would also be questions over the restatement of previous reporting.

QUESTION 9 - PLACEMENT OF THE INFORMATION

Chapter 6 presents an approach under which information discussed in Chapter 4 and Chapter 5 would be placed in the notes to the financial statements if the information is related to an item that meets the definition of an asset or to an item recognised in the statement of financial performance. In other cases, the information would be placed in the management report. However, it is noted that such an approach would result in information about intangibles to be spread between the notes to the financial statements and the management report.

Where do you think the different types of information that would follow from the approaches discussed in Chapter 4 and Chapter 5 should be placed? Should they be placed all in the same section or in different sections of the financial report, and why?

Nearly all intangibles whether capable of recognition as an asset or not, relate to items that are in the financial statements, if not in the statement of financial position then in the statement of financial performance. In determining information to be placed in the notes as opposed to the management report, Paragraph 6.12 appears to determine placement based on recognition as an asset, except when it comes to future oriented expenses. Greater clarity is needed here but dividing the disclosures between recognised assets and other intangibles does not seem the right approach.

Our suggestion is as follows:

- the accounting policy, judgements and analysis of intangible assets, their amortisation etc. should be in the notes to the financial statements.

- the further largely non-financial information about all or specific intangibles should be in the management report together with the risks and opportunities related to them. This seems more likely to lead to a more coherent discussion of intangibles in the context of other requirements for the management report such as the business model, the overall discussion of risks, strategy and performance measures.

- though disclosure of future-oriented expenses would seem to naturally fit in the financial statements, the degree of management judgement applying to them would mean their being better disclosed in the management report.

We also recognise that, in the European Union at least, sustainability standards and legislation may settle some of these placement issues.

References

ACCA research reports on intangibles
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