Deutsches Rechnungslegungs Standards Committee e.V.

Accounting Standards Committee of Germany

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Dear Jean-Paul,

EFRAG Discussion Paper *Better Information on Intangibles – Which is the best way to go?*

On behalf of the Accounting Standards Committee of Germany (ASCG) we are writing to contribute to EFRAG's Discussion Paper *Better Information on Intangibles – Which is the best way to go?* (herein referred to as the 'DP').

In our view, the DP provides a valuable contribution for the upcoming discussions on an improved reporting on intangibles. The three approaches proposed provide a good structure of possible solutions. Instead of deciding on one option we prefer to combine the three approaches since the very wide range of intangibles with different characteristics demand different solutions.

At present, approach 2 – Information Relating to Specific Intangibles – appears to be the most advantageous. In addition to the advantages mentioned in the DP, it is also advantageous that it is in line with the developments emerging in the CSRD.

Intangibles are often difficult to define and even more difficult to measure. Therefore, for many intangibles approach 1 – Recognition and Measurement – is not appropriate. They would lead to a significant reduction of objectivity of the data contained in the balance sheet and income statement. Users also point out that recognition and measurement of intangible (assets) on balance sheets are of secondary importance (vgl. Stuber "The Value of a Smile"). We thus remain committed to the basic concept of IAS 38, which in the DP corresponds to the "*conditional recognition"* approach in variant a) *"expensed in profit and loss until the condition is met"*. Furthermore, we also remain in favour of a cost approach in the balance sheet.

We note that approach 3 – Information on Future-Oriented Expenses and Risk/Opportunity Factors that May Affect Future Performance – is discussed in the user community. It could possibly become more important in the future. But the discussion paper does not describe the approach with sufficient clarity and depth. We see strong parallels with the IASB project on *Financial Statement Presentation.* The insights gained there should be included in the further discussions within the scope of this research project.

Finally, we consider the link to sustainability reporting, which has not yet been examined in the DP, to be extremely important. In this regard, we support an Integrated Reporting Framework and the statements by the chairman of the IASB Andreas Barckow and the chairman of the ISSB Emmanuel Faber from May 25, 2022. Also, we agree with the statement by the EFRAG TEG chair Chiara Del Prete in the press release on the DP highlighting that future reporting on intangibles and value creation is a key area for connecting financial and sustainability reporting. The continuation of the project should therefore reflect an integrated reporting on intangibles.

In view of the recent developments, further activities of this project and research should be aligned with the final CSRD provisions and the respective disclosures required under ESRS (e.g. on own workers) as well as with the future activities of the IASB and ISSB. Concerning an effective communication about intangibles EFRAG should support an approach that allows companies to report on intangibles in a coherent, consistent and integrated way. It is important to avoid duplication of reporting obligations and redundancies. Therefore, it is desirable that the international discussion on the further development of reporting on intangibles (e.g. the revision of the PS Management Commentary and a future research project on intangibles) contributes to the European discussion. Divergent requirements should be avoided.

Please find attached our comment letter, containing our detailed comments on the questions raised in the DP.

If you would like to discuss our comments further, please do not hesitate to contact Kristina Schwedler (schwedler@drsc.de) or us.

Yours sincerely,

Georg Lanfermann	*Sven Morich*
President	*Vice President*

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?

Yes. The issues listed and the need for an improved reporting on intangibles has long been discussed in the literature. Chapter 2 is a good description of the existing situation, the drivers, and the challenges. The resulting need for action is also validated by corresponding projects of national standard setters, e.g. FRC (2019), KASB (2019), AASC (2021) as well as by the discussions in the context of the IASB Agenda Consultation.

Are there additional issues with the current information on intangibles that are not listed? If so, what are these issues?

It would be worth discussing to what extent the dynamic discussions on sustainability reporting stimulate increased reporting on intangibles. The DP's explanations indicate that in future discussions EFRAG will consider the connection between financial and sustainability reporting (p. 19, par. 1.19). Focusing on financial reporting first is a practical solution. However, overlaps between the reporting contents require an integrative view of specific intangibles. This also becomes obvious by the examples in the DP (cf. p. 44).

In addition to the existing content in Chapter 2, the role of intangibles in understanding the business model should be discussed in detail.

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.

Yes, we believe there is room for improvement regarding information on intangibles in financial reporting. Several research activities of national standard-setters and the IASB's Agenda Consultation provide evidence.

Further, we consider the different approaches described could and should be combined. Intangibles cover a wide range of components influencing the enterprise value. They have dissimilar nature, which need be reflected in corporate reporting.

It is crucial that the level of uncertainty inherent in intangibles is obvious for users of financial reports. Due to uncertainty about investment outcomes, we believe that only intangible ASSETS that meet certain criteria should be included in the balance sheet and income statement. For the time being, the current IAS 38 approach should be maintained.

For enhanced reporting on intangibles, we particularly consider approach 2 – Information relating to specific intangibles – to be suitable. This approach is also in line with the CSRD proposal and future new European reporting requirements for intangibles.

In the future, a comprehensive reporting about intangibles requires a corporate reporting framework, incorporating principles and concepts from financial as well as from sustainability reporting.

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)?

As we think the different approaches described in the Discussion Paper could be combined this question remains unanswered.

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.*

Intangibles are regularly associated with high uncertainties and are therefore not included in balance sheet and performance measures even if the asset definition is met. As the problem has been discussed in the literature for years but has not been solved, the discussion paper also presents valuable considerations on the topic but no practicable approach to solving it.

Regarding the question raised in the DP *"Which type(s) of intangibles should be considered for recognition (and measurement)?"* we share EFRAG's view that the focus here should be on intangibles that meet the definition of an asset. In our opinion, the asset definition as well as the recognition criteria need to be met. We recognise that intangible assets have a high level of relevance, but the criterion of faithful presentation also must be fulfilled. We thus remain committed to the basic concept of IAS 38, which in the DP corresponds to the "*conditional recognition"* approach in variant a) *"expensed in profit and loss until the condition is met"*.

We nonetheless see potential for improvement regarding the criteria contained in IAS 38 for differentiating between research and development costs. The existing requirements in IAS 38 are more suited to traditional linear processes with definable milestones and less suited to modern research and development processes, such as agile software development. A revision of these criteria could lead to an increased recognition of research respectively development costs. It is also conceivable that the terminology would have to be revised.

Thus, we only consider the intangibles assigned to category A in the DP (cf. par. 3.1.) as qualifying for capitalisation. And of these, in turn, only the subset that fulfil the above-mentioned requirements of definition and recognition criteria. In our view the explicit recognition prohibitions in IAS 38 are clarifications and not exceptions to the recognition principle.

Regarding the frequently used evaluation issue *"performance measures will be distorted as not all intangibles are recognised"* the capitalisation and, in particular, the allocation to individual performance contributions in future years may be questioned critically. Is a practicable procedure with an added information value for investors and other stakeholder groups possible? The DP does not make any concrete findings in this regard.

Other theory-based insights regarding proper performance measurement and, in turn, proper asset recognition, can be provided by considerations of different accounting theories (e.g. dynamic and static). This could deepen understanding, but also does not answer how to deal with the uncertainties inherent in intangibles.

*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).*

As explained above, we only consider the intangibles assigned to category A in the DP (cf. par. 3.1.) as qualifying for capitalisation. And of these, in turn, only the subset that fulfil the above-mentioned requirements of definition and recognition criteria. As also mentioned above, in our view the explicit recognition prohibitions in IAS 38 are clarifications and not exceptions to the recognition principle. In this respect, they could also be deleted, but should not lead to an increase in the capitalisation of intangibles if the asset definition and recognition criteria are not met.

*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.

As explained above, we remain committed to the basic concept of IAS 38, which in the DP corresponds to the "*conditional recognition"* approach in variant a) *"expensed in profit and loss until the condition is met"*.

*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).

We consider all criteria to be relevant. Their relevance depends on the specific intangible in each case.

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')?

Even now the recognition of intangible assets is a challenging issue. However, the measurement of intangibles is even more challenging. It exists a variety of arguments for and against certain measurement bases.

As a result of our discussion, we prefer alternative a), the cost model. Some central arguments that lead us to this conclusion are:

- A measurement at acquisition cost is more in line with a "correct" performance determination (dynamic accounting theory) and is perceived as being more reliable.
- Regarding the revaluation model, it was determined that this can lead to the capitalisation of previous research expenses in subsequent periods. This conflicts with the preferred approach of *"conditional recognition"* in variant a) *"Expensed in profit and loss until the condition is met"*. In addition, it should be noted that the revaluation model is hardly used in practice due to the lack of active markets.
- However, a refusal to use fair value is inconsistent with its application in the context of a purchase price allocation (PPA) under IFRS 3. We recognise this conflict and that it is difficult to conclusively justify different measurement basis in IAS 38 and IFRS 3. Here it remains only to point out that the fair value approach in IFRS is used to determine deemed costs and that the increased recognition of intangible assets in the

context of a PPA was motivated by the introduction of the full goodwill approach and especially the impairment only approach. Furthermore, it can be argued that fair values are objectified by the consideration transferred.

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.

The questions address very specific aspects of the approach 2 "*Information relating to specific intangibles*". Therefore, the following basic remarks should be made first

This approach appears to be the most advantageous for improved reporting on intangibles in the near future. In addition to the advantages mentioned in the DP, it is in line with the developments emerging in the CSRD. Therefore, this approach should be further developed and the overlaps with the sustainability reporting and in the ESRS should be clearly identified. By way of example, reference is made to human capital / employees.

The disclosures should not only be limited to material intangibles; they should also be based on a common categorisation for better comparability. Numerous indicator models were developed in the context of discussions on (shareholder) value reporting in previous years. In Germany, for example, the working group "*Immaterielle Werte im Rechnungswesen"* of the Schmalenbach Society developed a classification and the proposal of an Intellectual Capital Statement.

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?

Yes, we agree. Information should be limited to the intangibles that are key to an entity's business model.

In particular we support to provide a description of the intangible, how it is related to the entity's value creation and linkage with financial performance. Also, the value creation through the interaction of intangibles is relevant here.

The management approach should be used as a basis, i.e. the decision on the items to be included and the composition of the relevant indicators should be made by the management. However, this also means that those items are selected that are relevant for internal control.

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?

We would first like to point out that only in limited cases fair value valuations are eligible. If this is the case, we generally agree that users must be able to evaluate the valuation. In individual cases, however, very granular input parameters are required; here it is questionable whether it is reasonable to disclose them all. Disclosure of very granular parameters is also problematic, not at least against the background of commercial sensitivity (for example, the disclosure of planned sales series at product level in order to evaluate a product brand; or the disclosure of planned margins).Therefore, we recommend besides a limitation to the key value drivers also a limitation on the key input factors including quantitative as well as qualitative disclosures in order to facilitate understanding of management's assessment.

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?

As mentioned in par. 4.56 whether providing information relating to specific intangibles would be more or less costly would likely depend on the specific circumstances.

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?

We are quite critical of the meaningfulness of such data, since, for example, the amount of marketing expenditure says nothing about the effectiveness of the activities associated with it. In our view, contextual KPIs (here e.g. the interaction rate) are necessary. Also, for example, with a view to project costs. What is the information value of such cost information? What does it say about quality of the project and its future potential? In our opinion, both cost-type-related and function-related data do not have per se an predictive resp. information value. Therefore, we believe this approach has a rather supplementary character.

Also, the explanations in the DP on this approach are not easily comprehensible and further explanations, especially on the informational benefit of this approach preferred by analysts, should be more clearly outlined.

We also note that it is not trivial to generate information according to the matrix included in the DP on p. 55 for the detailed breakdown of expenses recorded. A similar breakdown has already been critically discussed in the context of the "Financial Statement Presentation" project. a): should mainly complement information on specific intangibles.

With regard to sub-question b) we believe that the management's assessment is decisive. This is in line with our comment on question 5.2. and also, with other IFRS requirements, e.g. the assessment of the value in use for an impairment test. In this respect, alternative (i) ensures consistency. However, management should justify / explain its assessment decisions so that users can understand the underlying assumptions and – if necessary – make their own adjustments. In the end, this allows both alternatives to be implemented to some extent.

However, we consider that an objective distinction between future-oriented and non-future-oriented expenses is not possible. The crucial question here is how future-oriented expenses are defined in specific terms / in detail. As mentioned above, we believe that the efficiency and value contribution of a project/investment can be derived much better from other KPIs. Accumulated future-oriented expenses (including the aforementioned leeway) are comparably less meaningful.

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.

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 believe the disclosure of opportunities and risks affecting material intangible value drivers should be primarily qualitative, as quantification goes beyond the common status quo of existing risk reporting and is regularly not sufficiently robust. The robustness of data is questionable as the probability of their occurrence and the expected magnitude of their impact are often not quantifiable.

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?

We consider a common terminology on intangibles would be very useful. It should include a categorisation in addition to a definition. Several different approaches already exist. EFRAG seems to have engaged more thoroughly with the WICI work. As mentioned under question 5, in Germany, for example, the working group "*Immaterielle Werte im Rechnungswesen"* of the Schmalenbach Society developed a classification. Based on Edvinsson/Malone (1997), this classification subdivides intellectual capital into seven groups: (1) Innovation Capital, (2) Human Capital, (3) Customer Capital, (4) Supplier Capital, (5) Investor Capital, (6) Process Capital and (7) Location Capital.

2 Do you agree that preparers of financial statements should not be required to disclose information on intangibles that would be (very) commercially sensitive?

Yes, we agree. Preparers of financial statements should not be required to disclose information on intangibles that would be commercially sensitive. Furthermore, we refer by way of example to the NFRD, which has a corresponding clause: *"[…] the disclosure of such information would be seriously prejudicial to the commercial position of the undertaking, provided that such omission does not prevent a fair and balanced understanding of the undertaking's development, performance, position and impact of its activity."* (Art. 19a par. 1)

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?

There are no additional issues than those listed in Chapter 6 we think should be taken into account when considering how to provide better information on intangibles.

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?

We consider the proposed concept (in the notes 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 placed in the management report) does not work. The placement should depend on

- the nature of the information and
- function of the notes resp. management commentary.

Therefore, the decision hast to be made in the respective case. E.g. information about the progress and success of business combinations (as discussed in the context of IASB's Discussion Paper DP/2020/1 Business Combination – Disclosures, Goodwill and our comment letter (p. 4): *"Our preference for locating such information in management report over the notes is based on the objective of the document – namely, to provide information from a management's point of view over a longer term than is the case with the financial statements."*

More important than accumulating the information in one place is linking the information on intangible assets in the balance sheet, P&L / statement of financial performance, notes and management commentary from a holistic perspective; new challenges arise in this respect in the context of emerging sustainability reporting.