

30 June 2022

Via email: commentletters@efrag.org

Dear members of EFRAG,

Re: Discussion Paper: Better Information on Intangibles - Which is the best way to go?

The Corporate Reporting Users' Forum (CRUF) is delighted to respond to the EFRAG with our comments.

The CRUF was established in 2005 and we have been holding regular meetings since. The CRUF has prepared this comment letter based on discussions on this topic in CRUF meetings. As always, we do not seek to reach a consensus within the CRUF but to reflect a broad spectrum of users' views. We have highlighted any contrasting views in our response. Our comments are based on our professional experience as users of corporate reporting.

Overall comments

The purpose of the financial statements is not to explain the market capitalisation of an entity.

Rather, it is to assist users in obtaining the information necessary to make their own valuation assessment.

Intangible assets are already considered as a value driver along with tangible assets, whether they are "on-balance sheet" or "off-balance sheet". Several CRUF participants think that there is already sufficient information, in company reports and elsewhere, to carry out company valuations. Other CRUF participants think that there is insufficient information to carry out company valuations but recognise that the amount of information needed is often so extensive that it is sometimes preferable for the company to carry out the valuation following agreed norms – as is done, for example, for mining reserves.

Evaluating the economic value of internally generated intangible assets is a challenge, both because of the intrinsic nature of these assets and very poor disclosure. Better expense disaggregation is urgently needed to provide users with the historic costs so that users can estimate at very least the expenditure on various categories of internally generated intangibles.

Users generally would prefer more internally generated intangibles (under rigorous conditions) and fewer acquired intangibles (separate from goodwill) on the balance sheet. Several participants think that it would be helpful to recognise more internally generated intangible assets, according to strict criteria, as this would help reflect the capital invested in the business. In practice, this is what may users do themselves. They would prefer this to happen hand-in-hand with reducing the number of acquired intangibles that are recognised in a business combination because many of these intangibles, such as customer relationships, are generally not relevant to forecasts, so there is little benefit in separating them from goodwill.

Before addressing the specific questions in the discussion paper, we would like to share some practical examples of the challenges when dealing with intangibles, taken from the professional experience of CRUF participants:

1. An early stage software development company continues to invest heavily in its products and capitalises this expenditure. Whilst this means the company is showing as profitable, it is cash flow negative and needs ongoing capital funding. How should the VC investors presented with the proposed equity raise, value the company's intangible 'software development' asset?
2. A small, but well established, film production company's main income is commissions for new films and documentaries which it typically secures under cost plus contracts. These contracts often give the company royalty rights in carved out jurisdictions either immediately or after a certain period. The company has been in business for 12 years and has a track-record of earning increasing earnings from such royalty payments, but they can be lumpy and are in no way guaranteed. The royalty rights are not capitalised in any way. What are they worth?
3. A start-up spirits manufacturer has developed a strong niche brand for its one product through successful and targeted marketing of up-market on-trade venues such as premium independent hotels and restaurants. It has invested a lot of time in building strong relationships with these customers and established a strong loyal following. After 3 years of trading, the company is still loss-making and cash-flow negative, but it has cash resources to see it through to both profitability and cash-flow positivity based on its run-rate growth and on its conservative forecasts. Nevertheless, management is seeking a buffer and a small equity investment. What value should potential investors attach to the brand?
4. An established pharma company that invests more than its peers in R&D, training/skills and marketing might deserve a premium valuation if investors believe that this is going to pay off in the future through improved sales and profit margins. Conversely, companies that skimp on this type of spending might be put on a lower valuation multiple (reflecting lower forecasts of future cash flows and a higher discount rate) if investors believe there is a risk of loss of market share. The caveat is that the uncertain outcome of this 'investment' means that the extra spending, which reduces current profit margins, may turn out to have been wasted, e.g. R&D productivity is an important aspect in assessing pharma companies' prospects. What level of R&D spending is needed to maintain this business in the long-run?

Responses to the questions raised in the consultation that relate to the issues that concern investors are set out below.

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?

CRUF participants have additional comments on several of the listed issues:

Role of user vs. role of financial statements

Most CRUF participants think the role of the financial statements is as one of a number of inputs to their valuation assessments. This view is also reflected in the IFRS conceptual framework. Users need to know how much has been invested, which requires a clear view of historic cost. If management discloses, as supplementary information, their estimate of the future value, or if there is a market value, then this is also useful information.

Several participants noted that the qualitative information currently disclosed needs to be improved. Often the descriptions of intangibles on the balance sheet are very poor, with several different types of intangibles being grouped together (e.g., trademarks, patents, and technologies) making the valuation assessment very challenging indeed. One participant specifically notes a lack of information on the value and risk of acquired intangible assets as a result of a purchase price allocation (PPA) in M&A.

A counterview comes from a CRUF participant who says that the issues described above do not cause them much concern. They believe that financial statements provide a reliable platform for forecasting and do not agree that their value is shrinking. Whilst they agree return on asset ratios are not helpful for companies with significant internally generated intangible assets, they note that these companies tend to be valued via discounted cash flow models.

Performance measures

Return on assets is not useful for an intangible intensive business model as the 'assets' part is not a good reflection of the real economic value of the capital invested in the business.

Return on invested capital, conceptually, should include the intangible assets used by the business. Several CRUF participants define invested capital themselves and these bespoke calculations include some intangible assets, such as capitalised R&D using historic costs.

Return on sales may be distorted if costs incurred to build an intangible are not capitalised, as the income of a period is therefore not correctly matched with the related expenses. Operating margins are distorted since the statement of performance is 'hit twice' in the same period if an entity acquires an intangible asset (which is capitalised and amortised) and replaces this over time with an internally generated asset, which cannot be recognised and for which the costs are therefore recognised in the financial statements at the same time as the amortisation costs of the acquired intangible assets.

Expense disaggregation

One participant noted that users need much better expense disaggregation, ideally by function and nature. This is needed to allow them to capitalise the internally generated intangibles

themselves. For example, users not only need to have the R&D expense in total, but also how much is restructuring, depreciation and amortisation, so they are able to capitalise the remainder.

Another participant noted that the costs incurred to build an intangible asset already affect cash flow and the income statement, which are the financial statements they would tend to use to value companies where the balance sheet does not capture internally generated intangibles. The absence of the latter does not worry them much because measurement difficulty would make the balance sheet value suspect. Many of the costs are similar year on year, as you would expect, to maintain brands and intellectual property. So, capitalising and amortising is simply more complex than expensing as you go. Some of the same practical difficulties arise as in the idea of separating 'maintenance' capex from 'growth' capex: it sounds nice in principle but is difficult in practice and may invite management manipulation and spin.

However, another participant disagrees with the previous paragraph, as this would not be the case for a fast growing company because the expense and amortisation charge could be very different.

Several participants note that information on spending on intangibles may be difficult to compare because of poor definitions and patchy disclosure. Some of the ideas that would improve these disclosures are attractive.

Comparability between internally generated and acquired intangibles

Comparability is adversely affected as most intangible assets are not recognised if they are internally generated, but they are recognised if they are acquired. Comparability is adversely affected as intangible assets, acquired outside a business combination are only recognised if it is probable that the expected future economic benefits, attributable to the asset, will flow to the entity and the cost of the asset can be measured reliably. For intangible assets acquired in a business combination these criteria are always considered to be met; and/or, information (also narrative information) on intangibles is difficult to compare and use as the boundaries between different intangibles are not (well) defined and are interpreted differently.

Several participants do not regard acquired intangibles to be comparable with internally generated intangibles. The former has its own set of risks, including that the value of goodwill recognised on the balance will prove to be ephemeral, especially as companies often overpay for acquisitions. The "make" vs. "buy" decision is not a straightforward choice for intangible investments, because the choice is not necessarily simply "buy X" or "make X", rather it is often "make X from scratch" or "buy X as a proven asset" - the risk and reward profiles of each are very different.

CRUF participants believe that acquired intangible assets and internally generated intangible assets should be disclosed separately for accounting purposes. One participant highlighted that there is no current requirement to identify acquired intangibles separate from internally generated intangibles, although many companies do voluntarily. This is useful information and should be mandatory.

Number of intangibles

One participant has some sympathy with the case for reducing the number of acquired intangibles recognised in an acquisition that have to be separately identified and amortised, preferring the acquisition's cost to be carried on the balance sheet as goodwill and tested for impairment, albeit in a timelier manner. This, or other disclosures on how the acquired business is performing, would help them assess the return on that investment. Although they are not very concerned about the gap between accounting for acquisitive and organic growth, there may be a few ways in which IAS38 can be modernised to allow intangibles that do meet a rigorous definition of an asset to be recognised. The need for rigour is important because managements may be keen to capitalise and amortise expenses if this reduces upfront costs and smooths a spending trajectory that may necessarily be lumpy.

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)?**

The three approaches described in ES8 are appropriate. Several participants thought that the current rules can be improved upon significantly and, they believe, without too much additional cost.

A transparent management valuation of an intangible asset based on a prescribed approach within certain guardrails or parameters would be helpful to investors, particularly in those sectors where intangibles are key value drivers. It is important to remember that investors do not have to agree with the valuation, but it represents a starting point to have an informed discussion with management.

One participant supported the approach suggested in 3.43; in their view, these points may mean that the prohibitions in IAS 38 can be relaxed (That is, Category A in chapter 3; existence of expenditure as a precondition; reliable measurement of a separately identified asset; where there is a market for the asset).

Another participant expressed a counter view, noting that internally generated intangible assets are an important valuation issue; however, unlike acquired intangible assets, they should not be recorded on the balance sheet. They think that the valuation of internally generated intangible assets should be off-balance sheet but with additional disclosed information. This difference between “on balance sheet” and “off but with disclosure” often revolves around their confidence in the estimates. Users that are confident of the relevance and reliability of the estimate within a reasonable range tend to prefer them to be on the balance sheet. Users that are concerned about reliability tend to prefer them off-balance sheet.

Several participants supported better expense disaggregation, per chapter 5, as often happens with drug companies’ disclosures about their R&D spending, pipelines etc. This is sometimes referred to as “revenue investment”. The caveats include that management will want to classify as much spending as possible in the positive light of ‘investment’, that it can be difficult to disentangle maintenance spending from that designed to create growth, and that the entity may not control the positive outcome, e.g., better trained staff may leave.

Commenting on a business’s “value drivers”, per chapter 4, we feel this is in line with the principles of integrated reporting and can enhance the management commentary.

All of the above can be seen as complementary ways to improve the information available to users wishing to forecast cash flows, assess risks and opportunities, and pass judgement on management’s stewardship.

One participant suggested that two kinds of balance sheets should be prepared, one based on invested capital (at historic cost) and the other based on valuation (at fair value). Investors need the former to assess stewardship and return on historic investments, and the latter to assess future cash flows and the amount needed to be spent to maintain their intellectual property.

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.

- 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).**

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:
 1. Costs are expensed in profit and loss until the condition is met;
 2. Costs are capitalised and fully impaired until the condition is met, at which point in time the impairment losses are reversed;
 3. 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.

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)certainly 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 was no consensus on the conditional recognition proposal.

One participant notes that the nature of intangibles varies hugely from sector to sector. They could foresee that this approach could become too complex and costly to implement. If that were the case, then their choice would be the first option, i.e., level of (un) certainty about the outcome of the intangibles. The problem for early stage companies with certain types of intangible assets (like brands) is that this approach could lead to no recognition for some years.

All or a combination of the above factors are relevant depending on the nature of the intangibles. Identifiability, separability, and saleability all seem to be fundamentally necessary criteria and crucial to the ability to value an asset.

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')?

Several participants expressed a preference for the cost model and believe that this would provide the most reliable measure. Where there is an active market, fair value would also provide useful information. Initial and subsequent measurement at cost with amortisation and impairment ('Cost model').

One participant preferred initial measurement at fair value (as deemed cost) and subsequent measurement at cost with amortisation and impairment ('IFRS 3 model'). This option provides an easy reconciliation of ongoing expense versus value creation. A CRUF participants understands that preliminary feedback, received by EFRAG 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. One participant agreed with this, but another felt that with disclosure of the key estimation drivers, a rigorous methodology including management being required to explain the changes in key drivers annually, the valuation estimate would more likely be management's 'ungamed' best estimate, which would be useful information to have.

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.

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?

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?

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?

There is broad agreement that disclosure of quantitative and qualitative information is helpful.

A fair valuation on its own without any disclosure of the quantitative and qualitative information behind the valuation is less valuable if the key assumptions behind the valuation are not made clear. Both the valuation and the underlying information and assumptions should be disclosed. Management's fair value assessment is helpful, as a view on the value, but users are aware of the potential for bias and accept that their core role is to come up with their own view. Therefore, management discussion of changes in assumptions and the numerical impact of the changes would be key.

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?**

One participant noted that better expense disaggregation is urgently required. Whilst R&D is a required line item, advertising, training, and other forms of "revenue investment" are not and consequently they are rarely disclosed, and remain hidden in SG&A. Advertising, training, IT and customer acquisition costs in general would all be helpful.

Another participant noted that they were not convinced such a separation would be reliable and could be open to abuse. Just because money is expensed on something which management believes will be valuable in future, it often isn't. They prefer to limit management to specifics rather than giving them a freer rein to depict expenses towards some rose-tinted view of future revenue gains.

The separation of maintenance and growth is a tricky area because these terms are not well defined and in practice may be hard to distinguish between. The objective of a new standard should be to provide users with enough information to make up their own minds, but they will still depend on management disclosures. For example, if management claims year after year a substantial growth investment within a particular business line but there is no resulting growth, users can assume what is labelled as growth is actually only for maintenance.

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?

There is broad support for the proposals. However, it is difficult to judge the threshold of whether the information is commercially sensitive or not.

There was one participant who questioned why this information is presented as mutually exclusive from other disclosures about intangibles made in management commentary, e.g., in the principal risks section.

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?

Yes, as it assists with understanding and comparability. If it proves to be inflexible then it should also be adaptable, i.e., there should be a facility to add further terms and definitions over time. Definitions are important, especially when introducing change.

Disclosure standards often require management to disclose information that they would rather keep secret. Management has a natural tendency to make exaggerated claims about commercial sensitivity.

In certain circumstances this would not be in the interests of the investors for whose benefit this reform is intended. The right to ultimately decide what is commercially sensitive and what is not, however, should be with the auditor and not management and the fact and reason for the omission should be recorded in the accounts.

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?

In the cases where an intangible asset is recognised on the balance sheet, information should be in the audited footnotes. If it meets a materiality threshold it should also be in the management commentary.

Discussion of other intangibles, or 'value drivers', is normally found in the management commentary. Cross-references to the financial statements and footnotes are fine.

One participant noted that it is more useful to aggregate information than to disperse it. However, depending on the definition and scope of intangibles and the level of information disclosed, it is considered practical to include more quantitative and qualitative indicators in the financial statement notes and more descriptive information elsewhere.



About the Corporate Reporting Users' Forum (CRUF)

The CRUF was set up in 2005 by users of financial reports to be an open forum for learning about and responding to the many accounting and regulatory changes that affect corporate reporting. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters and regulators. CRUF participants include buy and sell-side analysts, credit ratings analysts, fund managers, investors and corporate governance professionals. Participants focus on equity and fixed income markets. The Forum includes individuals with global or regional responsibilities and from around the world, including Australia, Canada, France, Germany, Hong Kong, India, Japan, New Zealand, South Africa, UK and USA.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations depending on their area of interest or expertise. In our meetings around the world, we seek to explore and understand the differences in opinions of participants. The CRUF does not seek to achieve consensus views, but instead we focus on why reasonable participants can have different positions. Furthermore, it would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative. Also, it would not be correct to assume that nonparticipants agree with the initiative. This response is a summary of the range of opinions discussed at the CRUF meetings held globally and provided by participants in drafting the response. Differences of opinion are noted where applicable.

Participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer or other organisations they are a member of or associated with. Accordingly, we sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum and not as representatives of our respective employer or other organisations. The participants in the CRUF that have specifically endorsed this response are listed below.

Signatures

Jeremy Stuber

Jed Wrigley

Peter Reilly

Chie Mitsui

Peter Parry

Naoki Hirai

Masayuki Kubota, CFA

Jane Fuller

Sue Milton