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Comments on 'Accounting for Intangible Assets: Suggested Solutions'

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Accounting for Intangibles qua Accounting under Uncertainty

- Problems related to accounting for intangibles fall under a more general problem
- Authors abstract states ‘solutions centre on accounting under uncertainty’.
- My discussion will focus on this approach and the opportunities it provides for improved information and reporting

Investments and Uncertainty –
At time of investment – Separability issue

- Uncertainty – identification and measurement of investments
  - Can we separate expenditures that benefit the current period from expenditures that are intended to benefit future periods
    - Capital expenditures (yes-for the most part)
    - Inventory costs (cost of goods sold) (yes-for the most part)
    - Research expenditures (yes-for the most part)
    - Advertising (harder)
    - Training costs (harder)
  - If a particular expenditure will benefit more than one period, can we identify and allocate the portion of the expenditure that constitutes an investment when that investment is made to benefit future periods

Investments and Uncertainty –
Subsequent to investment – Outcome uncertainty

- Can we identify the consumption or exhaustion of an identified investment in the period(s) that it supports revenues?
  - Thereby, providing an appropriate amortisation schedule and an attendant income measure with minimal distortion.
- If the investment becomes impaired before it would support revenues, can we identify the impairment in the appropriate period?
- If so, we could report a periodic income measure (or information about that measure) that more closely approximates the underlying ‘economic performance’ of an entity over time
- Should be useful for both investment decisions and decisions related to assessments of stewardship

Financial Statement Solutions to Investments and Uncertainty
Initial recognition as an expense

1. Mixes investments with current expenses
2. Minimises subsequent mismatching from imprecise amortisation, but fails to provide appropriate matching over time
3. At present there is insufficient disclosure of items that are potentially investments (R&D is an attempt – and that is garbled under IFRS)
   a. IAS 38 ¶126 An entity shall disclose the aggregate amount of research and development expenditure recognised as an expense during the period.
4. Provides insufficient information if we take as evidence the many concerns raised over the inadequate reporting of intangibles

Financial Statement Solutions to Investments and Uncertainty

Initial recognition as an asset

1. Can correct the initial period mismatch; however, it still comes with the problems of separability and, especially, appropriate amortisation
2. Binary result – capitalise or not, does not convey the degree of uncertainty
3. Where uncertainty is high – may result in frequent impairment that provides little information about current or future performance
4. Unit of account issue – a portfolio of similar items can reduce overall uncertainty & make understanding the resolution of uncertainty more feasible

<u>Establishing a threshold for capitalization</u>

1. Restrict capitalisation to when 'an ex ante amortization schedule can be set with minimal ex post matching error, yielding informative earnings'.
2. Leaves problem of providing information on investments below threshold

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Conditional Capitalisation

1. Expense uncertain items, but identify them in income statement, also identify as a special account in equity, possibly in retained earnings (RE)
   a. If uncertainty resolves favourably - possibly capitalise and then amortise
   b. If uncertainty resolves unfavourably – possibly transfer to regular RE
2. This could provide significant additional information about the uncertainty of investments both at the time of the investment and subsequently
   a. Removes some of the noise from current earnings
   b. Potentially reduces some mismatching with respect to future earnings
3. This would be a radically different approach to partitioning the Income Statement - focused on providing better information concerning the uncertainty underlying investments and the resolution of that uncertainty (See also Barker and Penman CAR 2020)

Possible alternatives – that would provide better information (not necessarily mutually exclusive in whole or in part)

1. More precise principles on recognition that capture a viable threshold related to uncertainty
2. Conditional Capitalisation – need to work on refining novel entries and accounts to capture uncertainty related to investment and its resolution
3. Variant on conditional capitalisation provided in the notes
   a. Alternative Statements in notes - analogous to the changing price / general price level statements provided under the experiment in late 70s, early 80s
4. Variant on conditional capitalisation provided in Management Commentary
   a. IFRS Foundation would need cooperation for this to be adopted

Likely need to demonstrate feasibility and usefulness first before any of these, especially 2 to 4 would be contemplated

Possible Pragmatic Path

Start with the basic conditional capitalisation idea

a. Refine the idea by working with interested stakeholders including users and a set of willing entities
   - Focus on maximising information within a feasible cost-effective approach

b. Have the entities apply the developed approach in a set of experimental publicly available disclosures

c. Have users employ the information and provide feedback on its usefulness

d. Have auditors comment on feasibility of auditing the new information

e. Possibly some academic work through experiments and/or examination of price responses in the limited sample

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