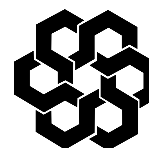

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International Accounting Standards Board

This document is provided as a convenience to observers at Standards Advisory Council meetings, to assist them in following the Council's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff paper prepared for the Council. Paragraph numbers correspond to paragraph numbers used in the Council paper.

INFORMATION FOR OBSERVERS

SAC Meeting: **November, London**

Project: **Agenda Proposal: Intangible Assets (excluding goodwill)** ***(Agenda Paper 4A)***

Cover note

I INTRODUCTION

1. The Board has received requests to add to its technical agenda a project on the accounting for intangible assets not acquired in a business combination (excluding goodwill). The staff plans to present an agenda proposal on intangible assets to the Board in December 2007. The draft agenda proposal is attached as appendix to this paper.

II Questions for the Standards Advisory Council

2. The purpose of this paper is to seek the Standards Advisory Council's input on the agenda proposal. The staff asks the Standards Advisory Council to consider the following questions:

   (a) Does the Standards Advisory Council believe that the staff has defined the project scope appropriately?

   (b) Does the Standards Advisory Council believe that the staff has appropriately analysed the IASB's standard setting criteria? Is the Standards Advisory Council aware of additional issues that should be included in the final agenda proposal?

[DRAFT] Agenda Proposal: Intangible Assets (excluding goodwill)

EXECUTIVE SUMMARY

1. The IASB's *Due Process Handbook* (March 2006) sets out the five criteria to be considered in deciding whether to add a potential item to the IASB's agenda. The FASB has similar agenda criteria. For convenience, this paper is structured around the IASB criteria.

2. Criterion 1 *the relevance to users of the information involved and the reliability of information that could be provided*: We conclude that intangible assets are an increasingly significant class of assets for a wide range of entities across many jurisdictions and that information about intangible assets is important to the needs of users. The issues are pervasive and, to the extent that the current requirements in IAS 38 are inadequate (see Criterion 2), the current accounting treatment will give rise to problems that are frequent and material unless resolved. Information about intangible assets that is not currently provided under IAS 38 is relevant to users and can be provided in a reliable way. We acknowledge that balancing the diverse views of users and others that currently exist on how best to account for intangible assets in a way that provides the most relevant and reliable information will be challenging for the Boards. The feasibility of arriving at a solution is considered in Criterion 4.

3. Criterion 2 *existing guidance available*: Our view is that many of the current requirements relating to intangible assets are considerably out of date and the information they generate does not appropriately reflect economic conditions or results. Minor amendments to current requirements would not be sufficient to adequately address these deficiencies. Consequently, we propose a fundamental review of current requirements.

4. Criterion 3 *the possibility of increasing convergence*: We conclude that, given the importance of intangible assets, there is a good prospect that an Intangible Assets project will gain support from national standard setters and regulators. Furthermore, conducting the project as an IASB/FASB joint project has the potential to facilitate convergence with respect to the accounting for intangible assets.

5. Criterion 4 *the quality of the standards to be developed*: Although it is necessarily a subjective assessment, on balance, we are persuaded that there is a range of potential project scopes and objectives that would lead to varying degrees of improvements to current requirements and satisfaction of users' needs. Irrespective of the scope and objective, we think that the benefits of improved financial reporting would exceed the costs.

6. Criterion 5 *resource constraints*: This criterion is addressed in the cover memorandum to the agenda proposal session.

7. We think that the relative urgency with which an Intangible Assets project should be initiated should have regard to the views of the SAC and FASAC and Criterion 5 *resource constraints*. Based on our assessment of the agenda criteria, our view is that

an Intangible Assets project should be added to the Boards' active agendas as soon as resources are available to commit to such a project. The scope of the project should be the initial accounting for identifiable intangible assets other than those acquired in a business combination (with a focus on, but not limited to, internally generated intangible assets) and the subsequent accounting for all identifiable intangible assets. The technical objective of such a project should be to identify appropriate recognition, measurement and presentation/disclosure requirements. In relation to measurement issues (cost versus fair value), we think that they should be resolved as part of the project process, rather than as part of the agenda decision process. If the Boards conclude that resources are not available to undertake such a project now, we would prefer that the project is delayed until resources become available.

8. Given the significance of the possible changes to current requirements if a comprehensive recognition-based project is undertaken, we do not think it is appropriate to move directly to an Exposure Draft. Instead, we propose that a Discussion Paper exploring the issues and setting out the preliminary views of the Boards is initially developed. A target period for developing the Discussion Paper is four years. An outline of the issues that might be addressed in the Discussion Paper is provided in Appendix 2. We also suggest that a Working Group (including users, preparers and regulators with practical experience and expertise in relation to identifiable intangible assets) is established to act in an advisory capacity.

9. Although our preference is for a single comprehensive project that incorporates a recognition objective, we acknowledge the ambitious nature of such an approach. Accordingly, this paper also contemplates alternative more narrowly scoped projects with less ambitious objectives, including a disclosure-only objective.

10. Given the range of possible scopes and objectives, paragraph 85 of this paper provides a decision aid to help facilitate the Boards' discussions.

INTRODUCTION

1. This paper sets out a proposal for a project on intangible assets to be added to the IASB's and FASB's technical agendas. Consistent with the timeline specified in the Memorandum of Understanding between the FASB and the IASB (27 February 2006), the Boards are scheduled to make "a decision about the scope and timing of a potential agenda project" in December 2007.

2. This paper has been developed by the Australian Accounting Standards Board (AASB) staff. Earlier drafts were discussed with the IASB at its October 2006 and January 2007 meetings and at the joint IASB/FASB meeting in April 2007. This draft incorporates the outcomes of those meetings, together with input from IASB staff and FASB staff.

POTENTIAL SCOPES AND OBJECTIVES OF AN INTANGIBLE ASSETS PROJECT

3. For the IASB, the term 'intangible assets' excludes goodwill. For the FASB, the term includes goodwill. In this paper, references to 'intangible assets' are to identifiable intangible assets and therefore do not include goodwill. The Boards have previously concluded that initial and subsequent accounting for goodwill would not be a fruitful line to pursue improvements in current requirements at this stage. The accounting for acquired goodwill has been subject to relatively recent review, as part of the Business Combinations Phases I and II projects. Accordingly, the initial and subsequent accounting for goodwill is excluded from the scope of this proposal. For similar reasons, the initial accounting for intangible assets acquired in a business combination is excluded from the scope of this proposal.

4. The definition of *intangible assets* contained in paragraph 8 of IAS 38 *Intangible Assets*, and adopted by IFRS 3 *Business Combinations*, is "an identifiable non-monetary asset without physical substance." We have adopted the IFRS 3 definition of intangible assets for the purpose of this paper. This is consistent with excluding the initial accounting for intangible assets acquired in a business combination from the scope of this proposal, and will help facilitate consistency in accounting across all

types of intangible assets (as defined), irrespective of the manner in which they arise. Despite this approach, given current practice issues, the project could include consideration of identifiability as the basis for the distinction between intangible assets and goodwill.

5. It is useful to categorise the intangible assets considered in this paper in a way depicted in Table 1 below. As reflected in the Table, this paper considers:

   (a) the initial accounting for intangible assets (other than those acquired in a business combination) that would be recognised if they were to be acquired in a business combination; and

   (b) the subsequent accounting for all intangible assets.

TABLE 1

INITIAL AND SUBSEQUENT ACCOUNTING
A: Internally generated
Arising from a discrete plan
Research and development (as defined in IAS 38)
In process
Contractual or other legal rights (eg patents)
Proprietary techniques (eg secret formula)
Other
In process
Contractual or other legal rights
Proprietary techniques
Relationships (eg customer list)
Arising other than from a discrete plan
Contractual or other legal rights
Proprietary techniques
Relationships
B: Separately acquired, including those acquired in exchange for a non-monetary asset or assets
C: Acquired by way of a government grant
D: Acquired in a group of assets or net assets that is not a business
SUBSEQUENT ACCOUNTING
E: Acquired in a business combination

6. The Boards have previously concluded that items B, C and D in Table 1 warrant relatively less attention than internally generated intangible assets (item A). This is because the issues transcend tangible and intangible assets. In particular:

   (a) *separately acquired intangible assets, including those acquired in exchange for a non-monetary asset or assets (item B in Table 1)*: The requirements in IAS 38 are relatively straightforward, typically give rise to the recognition and measurement of the intangible assets acquired, and are consistent with the requirements in IAS 16 *Property, Plant and Equipment* for property, plant and equipment acquired in the same way;

(b) *intangible assets acquired by way of a government grant (item C in Table 1)*: The main issue arises from the requirements in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. The issue concerns the treatment of the credit side of the journal entry that arises from the initial recognition of a granted asset, whether tangible or intangible. IAS 20 allows the credit to be treated as either: (a) deferred income; or (b) a deduction in arriving at the carrying amount of the asset. Although this issue warrants consideration, we think that it would be more effectively addressed separately from an intangible assets project. A further issue in IAS 20 that is pertinent to this project concerns the debit side of the journal entry. In particular, IAS 20 allows a non-monetary asset acquired by way of a government grant to be initially measured at either: (a) fair value; or (b) a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use. This issue could be considered as part of this project in the light of any conclusions drawn in relation to the measurement of intangible assets acquired other than by way of a government grant; and

(c) *intangible assets acquired in a group of assets or net assets that is not a business (item D in Table 1)*: These include intangible assets, such as use rights, acquired together with an underlying tangible asset. Many use rights (for example, copyrights, lease rights, mineral rights and exploration rights) stem from ownership of a tangible asset and involve unit of account issues and could be considered as part of this project. Paragraph 4 of IFRS 3 specifies requirements for assets acquired in a group of assets or net assets that is not a business. We note that the definition of a business has been revised as part of the Business Combinations Phase II project. The revised definition would reduce the circumstances in which the acquisition of an integrated group of assets or net assets would not constitute a business. Paragraph BC41 of the Basis for Conclusions on Exposure Draft of Proposed Amendments to IFRS 3 notes the view that, conceptually, acquisitions of all groups of assets should be accounted for in the same way to avoid the need to distinguish between groups of assets that are acquired in a business combination and those that are not. However, the Board decided not to extend the scope of the Business Combinations Phase II project to acquisitions of all asset groups because it noted that further research and deliberations of additional issues would be

required, which would delay implementation of the proposals.[1] We agree that the requirements in paragraph 4 of IFRS 3 should be subject to a separate review, but because IFRS 3 was issued and reviewed/revised only relatively recently, we do not think that the review should be part of this project.

7. Depending on conclusions drawn from our study of users' needs (see paragraphs 17 to 44) and our assessment of the Boards' resources (see paragraph 74 to 79), any one, some or all of the items within the internally generated intangible assets category (item A) in Table 1 could circumscribe the focus of a project. Once circumscribed, the primary technical objective of the project could be specified as either disclosure-only or recognition, measurement and disclosure. The scope of the project and the nature of the objective to be pursued would significantly affect the project's resource requirements and the length of time the project would take to complete. The more radical the potential change from current requirements, the longer we expect the project would take. Accordingly, in perceived ascending order of the degree of change from current requirements, on the assumption that a disclosure-only objective is less radical than a recognition-based objective, an Intangible Assets project may have a primary objective of:
   (a) specifying disclosures for internally generated intangible assets. These disclosures may be:
      (i) qualitative; and/or
      (ii) quantitative, including measurement at:
         A cost; and/or
         B fair value.

      The FASB has already done some work in this area as part of its own, since discontinued, Disclosures About Intangible Assets project. A summary of the project, together with a copy of part of the project proposal considered by the FASB in 2001, is provided in Appendix 3 of this paper;
   (b) resolving major definition, recognition and measurement shortcomings with IAS 38, including a review of one, some or all of the following issues:

1 A final Standard for IFRS 3 is expected in Q3 2007.

(i) the current research and development recognition criteria, with a focus on the suitability of 'technical feasibility' as a criterion (see paragraph 49(c)(i));

(ii) the current restrictions on revaluations of recognised intangible assets (see paragraph 49(d)); and

(iii) the application of the current definition of intangible assets in certain areas, including the distinction between intangible assets and:

A financial instruments (for example core deposits); and

B lease assets (for example land usage rights);

[Further input to be incorporated prior to December IASB meeting.]

(c) specifying recognition and disclosure of intangible assets developed from a discrete plan, initially and/or subsequently measured at:

(i) cost; or

(ii) fair value; and

(d) specifying recognition and disclosure of internally generated intangible assets, irrespective of the manner in which they arise. Within this approach, different initial and subsequent measurement bases that could be considered include:

(i) cost for all (which is effectively equivalent to the potential project (c)(i) above, because cost is unlikely to be available for intangible assets that do not arise from a discrete plan);

(ii) cost for internally generated intangible assets that arise from a discrete plan and fair value for others; or

(iii) fair value for all. From an initial accounting perspective, this could result in the principles adopted in IFRS 3 being applied to intangible assets acquired in a business combination being applied to internally generated intangible assets.

More details about this potential scope and approach is provided in Appendix 2.

Relative to each other, all of these possible projects have the potential to achieve, to varying degrees, improvements to current requirements and satisfaction of perceived users' needs.

8. Irrespective of the scope of the project, requirements could be developed that are different from one type of intangible asset to another. For example, signing a contract

or being granted a statutory right might be the appropriate recognition threshold for one type while a demonstration of 'technical feasibility' might be the threshold for others. Measurement may also be different from one type to another. For example, fair value measurement of a loan servicing right, which has contractually identifiable cash flows, is likely to be easier than measurement of relationships assets or the benefits of an advertising campaign. However, a risk of addressing small topics in isolation is that unwarranted differences in requirements would emerge for similar assets.

9. For the sake of clarity, we need to distinguish between initial and subsequent accounting, especially if the objective is recognition. This is particularly important in a transaction-based accounting model where an internally generated intangible asset is developed over a period of time under a discrete plan. To this end, for the purpose of this paper, 'initial accounting' includes: the accounting from the start of implementing a discrete plan to develop an intangible asset, through the in-process phase and ending at completion or abandonment of the discrete plan. This definition is consistent with treating any further development under a discrete plan of, for example, an in-process research and development asset acquired in a business combination as part of the initial accounting for the asset. This definition itself spawns further candidates for definition, including 'discrete plan' and 'completion'. The definitions of these terms should be considered as part of an Intangible Assets project where appropriate.

10. Both private sector and public sector not-for-profit entities, for example research universities, may have intangible assets. Depending on the nature of the solution to be developed for the shortcomings in current accounting requirements, the not-for-profit environment may give rise to additional issues relative to for-profit issues. For example, fair value measurement issues in a not-for-profit environment are more complex where attributable cash flows are absent. However, we expect that the principles to be developed from this project would be applicable to intangible assets, irrespective of the objectives of the entity holding them, and therefore this paper is written from a sector-neutral perspective.

11. The remainder of this paper:

(a) considers whether an intangible assets project would meet the IASB's agenda criteria (paragraphs 12 to 79). The discussion is undertaken in the context of the range of potential scopes and objectives identified in paragraph 7 before we express our view on scope and objective in paragraphs 80 to 81. Paragraph 85 provides an aid to facilitate the Boards' deliberations of our view and the alternatives; and

(b) sets out a proposed project plan (paragraphs 86 to 89, in conjunction with Appendix 2 for our preferred approach, and in conjunction with Appendix 3 for an alternative to our preferred approach).

AGENDA CRITERIA

12. The IASB's *Due Process Handbook* (March 2006) sets out the following five criteria to be considered in deciding whether to add a potential item to the agenda:

    Criterion 1: The relevance to users of the information involved and the reliability of information that could be provided;

    Criterion 2: Existing guidance available;

    Criterion 3: The possibility of increasing convergence;

    Criterion 4: The quality of the standards to be developed; and

    Criterion 5: Resource constraints.

13. The FASB's agenda criteria (referred to as 'factors': pervasiveness of the issue, alternative solutions, technical feasibility, practical consequences, convergence possibilities, cooperative opportunities and resources) are similar to the IASB's agenda criteria. For convenience, this paper focuses on the IASB's agenda criteria.

Criterion 1: The relevance to users of the information involved and the reliability of information that could be provided

Magnitude and pervasiveness of intangible assets

14. Given that many intangible assets currently are not recognised or disclosed, it is difficult to estimate their magnitude and pervasiveness. However, their order of magnitude and pervasiveness can be estimated indirectly. For example, although

research and development is not the only way in which intangible assets arise, and acknowledging that efforts do not necessarily result in assets, various statistical reports indicate a significant level of research and development activities:

(a) The National Science Foundation Division of Science Resources Statistics reports that: "U.S. R&D grew to $291.9 billion in 2003 after declining in 2002 for the first time since 1953" (page 1), and notes that the business sector "performed 70% of U.S. R&D in 2004" (page 1).[2] The report goes on to note that: "Although spending on R&D in the United States far exceeds spending in any other country, several nations report higher R&D/GDP ratios" (pages 4-5); and

(b) The Organisation for Economic Co-operation and Development (OECD) reports that OECD-wide investment in research and development reached $US 729 billion in 2004. It goes on to report that: "Recent growth in R&D spending have been highest in the United States (4% a year between 2002 and 2004), followed by Japan (2.1% a year between 2000 and 2004) and EU25 (2.3% a year between 2000 and 2003)."[3]

15. Market-to-book ratios (the ratio of market capitalisation to the carrying amount of net assets of an entity) are sometimes invoked as a measure of the magnitude of intangible assets and the relative importance that investors place on them. In addition, the recent upward trend in mean market-to-book ratios is sometimes used as evidence of the 'new economy', characterised by the arrival of a new breed of more valuable unrecognised intangible assets.[4] Stock prices relative to book values, however, are an imperfect measure of the value attributed by investors to unrecognised intangible assets. Nevertheless, the increase and increasing volatility in the mean market-to-book ratios since the mid-1980s identified by authors such as Lev (2001) and Beattie and Thomson (2005) arguably reflect: (1) intangible assets becoming an increasingly

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2 'InfoBrief' ('U.S. R&D Continues to Rebound in 2004' January 2006, page 1) issued by the National Science Foundation, Directorate for Social, Behavioral, and Economic Sciences, Division of Science Resources Statistics.

3 OECD (2006), 'OECD Science, Technology and Industry Outlook, Highlights, 2006', page 1. The reference to 'EU25' is to the twenty-five European Union countries at the time of the report.

4 See Lev, B. (2001), 'Intangibles: Management, Measurement, and Reporting', The Brookings Institution Press, Washington, D.C., page 8; and Beattie, V. and Thomson S.J. (2005), 'Intangibles and the OFR', *Financial Management*, June 2005, pp. 29-30.

significant driver of corporate value; and/or (2) investors becoming increasingly aware of the role that intangible assets play with respect to corporate value. However, anecdotally, since the dot-com bubble burst (see paragraph 41), there would seem to be less concern from some commentators that financial reports do not fully reflect intangible assets.

16. Even a cursory consideration of the nature of various types of businesses provides a reasonable basis for concluding that intangible assets are integral to the operations of a large number of entities across a range of industries and jurisdictions. Further support for this conclusion can be found in the types and magnitude of intangible assets that are now being recognised in accordance with the current requirements for accounting for business combinations. Examples of industries and types of intangible assets include:
    (a) pharmaceutical companies (for example, intangible assets arising from research and development, and drug patents);
    (b) information technology companies, including web-based entities such as internet search engine developers and providers, and software development companies;
    (c) media companies (for example, mastheads);
    (d) consumer product companies (for example, brands and trademarks);
    (e) service-based companies (for example, customer relationships); and
    (f) financial services companies (for example, mortgage servicing rights and investment management rights).

    Given their nature, most entities would be expected to have at least one type of intangible asset, such as customer lists, customer contracts and related customer relationships, non-contractual customer relationships, licence agreements and internally developed software.

Needs of users

17. IAS 38 places significant limitations on the types of intangible assets that entities are permitted to recognise and the initial and subsequent measurement of those assets. It also prescribes disclosure of only a minimal amount of information about intangible assets. These limitations undermine the relevance and reliability of information

available to users through general purpose financial reports. Specific criticisms of the limitations are detailed under Criterion 2 *existing guidance available* (paragraph 49) and are therefore not repeated here. Overcoming the criticisms by finding technically feasible solutions would improve the relevance and reliability of information provided in financial reports.

Users' Views

18. To help us assess the relevance to users of the information involved and the reliability of information that could be provided (recognised and/or disclosed), we have ascertained the views of some users. Our findings are discussed below.

19. Some sophisticated users have consistently asked for the recognition of more intangible assets in addition to those acquired in a business combination. For example, in 1993 the AIMR[5] (now the CFA Institute) concluded that:

> … financial reporting can be modified so as at least to recognize more of the economic reality of intangible assets than it does now (page 52).

More recently, inadequacies in the current requirements were noted by the CFA Institute[6]:

> Today, many companies in global markets are driven by the creation and use of intangible assets. Indeed, much of the major economic growth worldwide is attributable to such assets. The current reporting model is deficient in its requirements for transparent recognition and disclosure for these assets. Investors must have the information they need to understand, analyze, and value intangibles-dependent companies. (page 3)

20. In contrast, other sophisticated users express strong reservations about the recognition of intangible assets. These reservations were expressed, for example, at the Corporate Reporting Users Forum (CRUF) at the IASB in January 2007, at the Analysts Representative Group meeting at the IASB in February 2007, by PricewaterhouseCoopers (2007)[7] interviewees and Canadian Users Advisory

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5 Association for Investment Management and Research (AIMR) (1993), 'Financial Reporting in the 1990s and Beyond'.

6 CFA Institute (2005) 'A Comprehensive Business Reporting Model: Financial Reporting for Investors' (24 October), which is a Draft, prepared by the CFA Centre for Financial Market Integrity.

7 In its survey of investor views, 'Measuring Assets and Liabilities: Investment Professionals' Views' (February 2007)), PricewaterhouseCoopers met in late 2006 with over 50 buy-side and sell-side investment professionals in Boston, London, and New York, as well as a small number of investors

Committee members, as discussed in the following paragraphs. Their reservations appear to be particularly related to the measurement basis that they expect might be adopted and concerns about the current measurement basis adopted for internally generated intangible assets and intangible assets acquired in a business combination.

21. In relation to cost-based measurement, many users described the current model as confusing, particularly as some research and development expenditure is capitalised and some expensed. A concern expressed at the IASB measurement roundtables is that failure to capitalise costs incurred on internally generated intangible assets allows entities to manage earnings (particularly in the short-term) by, for example, cutting research and development expenditure. A minority of PricewaterhouseCoopers interviewees supported the capitalisation of research and development; a majority expressed a view that research and development should be expensed.

22. PricewaterhouseCoopers found pervasive concerns about the adoption of any form of current value measurement for illiquid assets, including intangible assets. Many of the interviewees questioned managements' ability to provide reliable estimates of current value and expressed concern about the potential for changes in current value estimates to mask operating performance, given the current presentation of the income statement. It appears that many analysts view the task of estimating the current value of various assets and liabilities (both on and off balance sheet) in determining the value of an entity as part of their role, not the role of management and/or accountants. They believe that they can better ascribe a value to intangible assets. If management were to attempt to put a market value on an asset, they argue that it would usurp the market's role of valuing assets.

23. Seventy-four percent of respondents interviewed by PricewaterhouseCoopers described the item 'intangible assets' recognised in the balance sheet as "not useful". PricewaterhouseCoopers concluded that respondents are more interested in the nature of, and expenditure on, intangible assets than in the treatment of intangible assets in the primary statements.

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based in San Francisco, Frankfurt, and Toronto to discuss their use of the balance sheet in their analysis of performance.

24. PricewaterhouseCoopers respondents also expressed a view about current value measurement more generally, stating that, **if** a current value measure is to be provided:

- the key assumptions/drivers should be disclosed to facilitate comparisons across entities and evaluations of sensitivities and reasonableness;
- remeasurement gains and losses should be excluded from the operating performance; and
- ranges of outcomes rather than point estimates should be disclosed.

25. Some users acknowledge that the recognition of intangible assets at fair value, or even at capitalised cost, might provide useful information. However, they have reservations as to whether this is better than having more disclosures about intangible assets (for example, disclosure of research and development expenditure on a project-by-project or aggregate basis), and the other drivers of entity value, in the management commentary to enable investors to better forecast future cash flows. Some users think that historical cost provides no useful information for forecasting future cash flows.

26. We note that paragraph 82 of the *Framework* comments that failure to recognise items that otherwise meet the recognition criteria is not rectified by disclosure of the accounting policies used nor by notes or explanatory material (see also paragraph 16 of IAS 1 *Presentation of Financial Statements*). Experience under SFAS 123 *Share-Based Payment* illustrates that disclosed measurements may not be prepared with the same level of robustness as recognised measurements.[8] However, a disclosure-only solution arguably has merit as an interim step. Benefits of a disclosure-only interim solution include that it would allow entities to become accustomed to the idea of identifying and measuring internally generated intangible assets, it helps alleviate the question of when internally generated intangible assets should be recognised, and it would provide empirical data about items that would not otherwise be disclosed. Disclosures could also facilitate the dissemination of information about intangible

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8 See, for example, Libby, R., Nelson, M.W. and Hunton J.E. (2006), 'Recognition v. Disclosure, Auditor Tolerance for Misstatement, and the Reliability of Stock-Compensation and Lease Information', *Journal of Accounting Research*, Volume 44, pp. 533-560.

items that do not meet the definition or recognition criteria for assets, such as knowledge capital and assembled workforce.

27. Some at the Analysts Representative Group meeting with the IASB in February 2007 expressed a view that assets acquired and internally generated should be treated the same way. They noted that it would seem odd to recognise more or fewer intangible assets in an acquisition than an entity would recognise prior to the acquisition. There was also some acknowledgement that analysts do not look at information about intangible assets as much as they should.

28. In response to a series of questions about various aspects of accounting for intangible assets, we have received written responses from 11 members of the Canadian User Advisory Committee (UAC). These include a lender, a regulator, investors, a buy-side analyst, and venture capitalists. On the question of the suitability of applying the principles for the recognition and measurement of intangible assets acquired in a business combination to internally generated intangible assets, the views were mixed. Some expressed concerns about the absence of an arm's length transaction for internally generated intangible assets, leaving no basis for determining objective value other than development cost, and thought that benefits would not outweigh the costs of preparation and audit. One investor expressed a view that the principles would be appropriate for identification of internally generated intangible assets but not for measurement purposes. Others expressed a view that, given the increased significance of internally generated intangible assets, the appropriateness of ascribing fair valuation is self-evident. The buy-side analyst commented that if an entity has made the effort to secure contractual or legal rights in regards to an intangible asset, then the value of that income stream should be considered part of its asset base. An investor commented that initial recognition of internally generated intangible assets would allow analysts to perform valuations on the break-up value of an entity.

29. On the question of the suitability of subjecting recognised intangible assets to revaluations, consistent with reservations about reliability of fair value measurement, most UAC members surveyed expressed apprehension with the prospect of entities being permitted or required to revalue intangible assets. Those who supported initial recognition of internally generated intangible assets generally supported a cost model

(with amortisation and/or impairment) for subsequent measurement purposes. An investor commented that, while there would be merit in adopting a revaluation model provided that all assets are measured at fair value, this approach is likely to give rise to a number of audit issues. Those who supported a revaluation model did so on the basis that it would improve financial reporting, it makes intuitive sense, and it would render the data more current.

30. We note that the views we have been able to ascertain are from those users who are organised in such a way as to be able to convey their views to standard-setters. They are at the relatively highly sophisticated end of the spectrum of users of financial reports identified in the *Framework*. The July 2006 Discussion Paper *Conceptual Framework for Financial Reporting* identifies a wide range of users. Paragraph BC2.40 notes that: "The boards observed … that financial reports should be understandable by both sophisticated and relatively unsophisticated users. … It follows that some types of entities, for example, entities with a significant number of relatively unsophisticated equity holders, may need to be especially careful to ensure that those users can understand the entity's financial reports."

31. The views of relatively highly sophisticated users provide important input to the Boards' deliberations. Other, relatively unsophisticated, users might hold a different view from some of the views noted above. For example, there may be a significant number of users who are interested in management's assessment of current values. It is difficult to ascertain the views of such a disparate group. Nevertheless, arguably the standard-setter has a responsibility to ensure that the interests of such lower-profile users are protected. Therefore, standard-setters may need to stand in the place of these users and decide on what is in their interests, using the *Framework* as the basis for decisions. This approach would be particularly valid to the extent that the *Framework* is developed having regard to the needs of the lower-profile users. It is apparent from paragraph QC41 of the Discussion Paper *Conceptual Framework for Financial Reporting*, which addresses understandability, that the *Framework* is being developed having regard to the needs of relatively unsophisticated users.

32. Some think that the users' views we have identified do not support a conclusion that an accounting solution is feasible, and, even if an accounting solution is supported,

the views do not help identify which technical objective should be pursued. Accordingly, they think that further investigation of users' needs is warranted. They note that this investigation might conclude that financial reporting is not the best vehicle by which information required by users about intangible assets is conveyed (perhaps due to users' needs for information about items that have value [economic assets] but do not fulfil the definition criteria of an accounting asset). They think, therefore, that consideration should be given to whether financial reports are the appropriate vehicle for systematically conveying information related to intangible assets to the market. There may be non-accounting solutions for conveying the relevant information systematically to users. If non-accounting solutions are identified, they argue that the Boards should consider how best standard-setters could contribute to such solutions rather than develop an accounting solution.

33. However, we think that, when considered in the light of the rest of this proposal, paragraphs 19 to 31 above provide sufficient insight into users' views as a basis for the Boards to make a judgement about an Intangible Assets project. We note that users' views are rarely consistent and their diversity can be used to justify any one of a range of potential project scopes and objectives, and even justify no project.

34. Users and management might have incentives, depending on their particular circumstances, to favour one possible approach to intangible assets over another possible approach, regardless of the conceptual basis for the approach. For example:
    (a) Some might support not recognising (or even disclosing) intangible assets despite the conceptual merits of recognition (or disclosure) because:
        (i) greater transparency in the accounting for intangible assets would potentially undermine the competitive advantage that:
            A some entities presently derive from unrecognised and undisclosed (secret) intangible assets that, if presented in the financial report, would cease to provide the level of benefits that would otherwise be expected; and
            B some analysts and valuers presently derive from their proprietary models developed to address inadequacies in the current financial reporting model; and
        (ii) they are concerned about volatility of profits; and

(b) Some might support recognising intangible assets despite the conceptual merits of non-recognition because the recognition of intangible assets would enhance the apparent strength of the balance sheet.

We think that the project should seek to identify conceptually sound improvements to IAS 38, having regard to practical considerations. In doing so, the motives noted above should be acknowledged as potential impediments to finding appropriate solutions.

35. Irrespective of the scope and objective of the project, we think that it is important to continue to engage a wide range of constituents (including users) throughout the project, including in the early stages. This should build on the findings reflected in this proposal and include identifying the aspects of current accounting for intangible assets that users find useful, the information they need that they currently cannot access, and the information they do not find useful.

Insights from Academic Studies

36. Recent research indicates that the current requirements in IAS 38 limit the usefulness of financial reports and therefore the needs of users are not being met in the most effective way.

37. Prior to the adoption of IFRS in Australia, Barth and Clinch (1999)[9] investigated whether relevance, reliability and timeliness of asset revaluations in Australia differ across types of assets, including investments, property, plant and equipment, and intangible assets. The study found that revalued amounts in excess of historical cost are value relevant, where 'value relevant' is described as "the amount has a significant relation in the predicted direction with share prices or the non-market-based estimate of firm value" (page 200). This finding supports the view that the recognition, measurement and revaluation (or at least disclosure) of intangible assets are important from a capital markets perspective.

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9 Barth, M.E. and Clinch G. (1999), 'Revalued financial, tangible, and intangible assets: associations with share prices and non-market-based value estimates', *Journal of Accounting Research*, Volume 36, pp. 199-233.

38. Matolcsy and Wyatt (2006)[10] found capitalisation of intangible assets encouraged higher analyst following and lower absolute earnings forecast errors for firms with a stock of underlying intangible assets. Barth *et al* (2001)[11] also examined the relationship between analyst coverage and firms' intangible assets. They concluded that:

> Taken as a whole, our evidence points to an important potential implication of non-recognition of intangible assets. In particular, intangible assets, most of which are not recognized as assets in firms' financial statements, are associated with greater incentives for analysts to cover such firms, and greater costs of coverage. An unanswered question is whether financial statement recognition of intangible assets could more efficiently provide information about such assets to investors. (page 30).

Although the Barth *et al* findings do not throw light on the recognition versus disclosure-only solution, the findings strongly suggest that if financial reports were to provide greater information about intangible assets, costs of coverage are likely to reduce.

39. Amir *et al* (2003)[12] investigated whether the information available to investors from sources other than financial reports make up for the reports' deficiencies in general, and in intangibles-intensive companies in particular. The authors conclude that:

> Our findings are somewhat mixed – they indicate that analysts' incremental contribution to investors' decisions is larger in R&D-intensive companies than in companies with low levels of (or no) R&D, indicating that the intangibles-related financial report deficiencies are compensated to some extent by other information sources, through analysts' activities. However, this compensation is modest and far from complete, as indicated by the documented association between R&D intensity and the quality (bias and accuracy) of analysts' forecasts. … our evidence suggests the need for a continued concern and action of accounting policymakers with intangibles-related information deficiencies. Sadly, as of this writing, such action has been negligible. (page 657)

40. Gu and Wang (2005)[13] found a positive association between analysts' forecast errors and the forecast firm's relative intangible intensity. The authors also found that

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10 Matolcsy, Z. and Wyatt, A. (2006), 'Capitalized intangibles and financial analysts', *Accounting & Finance*, Volume 46, pp. 457-479.

11 Barth, M.E, Kasznik, R, and McNichols, M.F. (2001), 'Analyst Coverage and Intangible Assets' *Journal of Accounting Research*, Volume 39, pp. 1-34.

12 Amir, E, Lev, B, and Sougiannis, T. (2003), 'Do Financial Analysts Get Intangibles', *European Accounting Review*, Volume 12, pp.635-659.

13 Gu, F. and Wang, W. (2005), 'Intangible assets, information complexity, and analysts' earnings forecasts", *Journal of Business Finance and Accounting*, Volume 32, pp. 1673-1702.

analysts' forecast errors are smaller for biotech and pharmaceutical and medical equipment firms that are subject to intangibles-related regulation.

41. As indicated in paragraph 15, during the dot-com bubble period (roughly 1995-2001[14]) there were major gaps between book values of many start-up and high-tech businesses and their perceived business values. At the time, these gaps led to some calls for standard-setters to give consideration to improving accounting for intangible assets. With the bursting of the bubble, those major gaps closed considerably or evaporated with the demise of many of those businesses. Those changes leave some commentators less confident about the true depth and nature of users' needs that may have been perceived by some of the academic research during the dot-com bubble period.

Constituents' views on the priority of an intangible assets project

42. The SAC considered its views on the priority of an Intangible Assets project at its 26 June 2007 meeting. Particular consideration was given to a comprehensive recognition-based project (along the lines of that described in paragraph 7(d)). The outcome of that meeting is that, although some SAC members acknowledged the importance of intangible assets, there seemed to be stronger support for the present IASB projects, such as the Conceptual Framework project, and other potential IASB projects, such as the Management Commentary project.

43. Subsequent to their meeting with the IASB in January 2007, eleven members of the CRUF wrote to the Chairman of the IASB (in a letter dated 1 August 2007) expressing their view on the priority of an Intangible Assets project. They express a strong view that the IASB should not add the project to its active agenda because they believe that the information that would result from the project would not be sufficiently relevant to operating performance and therefore would not be valuable to CRUF members as investors. They note that reporting on intangible assets is much more suited to the management commentary than the balance sheet and are keen to support the IASB in its efforts in this area. They would prefer the IASB to

14 http://en.wikipedia.org/wiki/Dot-com_bubble (July 2007).

concentrate its scarce staff resources on areas which are of greater interest to most users (such as financial statements presentation, pensions accounting and lease accounting). They are also keen to see substantial progress on the Conceptual Framework at a swifter rate than that currently timetabled.

44. From a FASB perspective, the FASAC is scheduled to consider its views on project priorities at its September 2007 meeting. The outcome of that meeting will be incorporated into this paper in due course. *[Further input to be incorporated prior to December IASB meeting.]*

45. In 2001, when the FASB was considering adding a Disclosure About Intangible Assets project to its agenda (see Appendix 3), many constituents expressed a view that other present and potential FASB projects are higher in priority. For example, the AIMR expressed reservations about supporting the project "if resource constraints of the FASB would prevent it from addressing other projects for which there is an immediate need. In particular, we believe that if the Board has to choose between projects, then addressing revenue recognition, the recognition of financial instruments at fair value, and comprehensive income should be given higher priority than disclosure for unrecognized intangibles." PricewaterhouseCoopers said "We continue to believe that a project on performance reporting should be the Board's top priority. However, revenue recognition is an important area as well and, in our view, deserves equal attention with the planned project on intangible assets." It would seem that, although expressed some years ago, similar circumstances exist today, and the comments indicate that constituents have mixed views on the priority that should be attributed to an intangible assets project. To some extent, the priorities are dependent on resource constraints, which are discussed under Criterion 5.

Conclusion on Criterion 1

46. Based on the above, we conclude that intangible assets are an increasingly significant class of assets for a wide range of entities across many jurisdictions and that information about intangible assets is important to the needs of users. The issues are pervasive and, to the extent that the current requirements in IAS 38 are inadequate (see Criterion 2), the current accounting treatment will give rise to problems that are frequent and material unless resolved. Information about intangible assets that is not

currently provided under IAS 38 is relevant to users and can be provided in a reliable way. We acknowledge that balancing the diverse views of users and others that currently exist on how best to account for intangible assets in a way that provides the most relevant and reliable information will be challenging for the Boards. The feasibility of arriving at a solution is considered in Criterion 4. The relative urgency with which the issues should be addressed should have regard to the views of the SAC and FASAC and Criterion 5 *resource constraints*.

Criterion 2: Existing guidance available

47. IAS 38 includes requirements for the initial accounting for intangible assets other than those acquired in a business combination and the subsequent accounting for all intangible assets. There are differing views as to whether the requirements in IAS 38 are appropriate in the current environment.

48. The requirements for intangible assets specified in IFRS differ from the corresponding requirements in US GAAP in many respects (see Appendix 1). This paper primarily refers to IFRS. Broadly, compared with IFRS, US GAAP permits fewer intangible assets to be recognised. Given that the main focus of the discussion in this paper relates to the consequences of the non-recognition/non-disclosure of intangible assets, the conclusions reached are similarly pertinent in a US GAAP context.

49. Some regard many IAS 38 requirements as inappropriate. We support this view because the current requirements undermine the relevance and reliability (faithful representation) of general purpose financial reports. IAS 38 fails to require the recognition of items that satisfy the asset definition and recognition criteria and fails to require disclosure of adequate supplementary information. Accordingly, users are deprived of information relevant to an assessment of the financial performance and position of an entity. This can lead to systematic undervaluation or ill-informed speculation of intangible-intensive entities, and insider trading. It can also cause an

imbalance in investment decisions against 'start-up' enterprises.[15] Particular criticisms of IAS 38 include the following:

(a) The disclosure requirements in IAS 38 do not provide adequate information for users to assess an entity in relation to its recognised and unrecognised intangible assets.

(b) Users are deprived of information to assess management's accountability for the assets under its control, unless that information is provided voluntarily. Consequently, management may not be given credit for enhancing the value of intangible assets, and may be insulated from responsibility for destroying the value of the same assets. Lev (2001) observes:

> immediate expensing … and virtually no information disclosure about the progress of products under development or of return on investment suit managers well, particularly given the generally high level of uncertainty associated with intangibles. Failures generally draw attention more than do successes, and immediate expensing upon acquisition or investment, as well as minimal disclosure about project development, obscures most failures. (pages 89-90)

However, we should acknowledge that, while significant changes in the value of intangible assets would be relevant to the decisions of users, not all changes in value of intangible assets (whether recognised or unrecognised) are necessarily attributable to management. For instance, the 1982 Tylenol poisonings in the US had a significant financial impact on Johnson and Johnson, its subsidiary McNeil Consumer Products (the company that made Tylenol) and the Tylenol brand. Johnson and Johnson's management of the situation, however, is generally regarded as the principal reason for the brand's recovery.[16]

(c) IAS 38 prohibits the recognition of many internally generated intangible assets. This is inconsistent with:

(i) the recognition of internally generated tangible assets (for example, under IAS 16). IAS 16 contemplates capitalisation of costs from commencement of construction of a tangible asset. In contrast, in relation to intangible assets generated from research and development, IAS 38 requires all research costs to be expensed and only contemplates capitalisation of development costs after the entity is able

15 See Lev (2001), pages 95 to 102.

16 Knight, J. (1982), 'Tylenol's maker shows how to respond to crisis', *The Washington Post*, October 11.

to demonstrate that certain criteria are met (including technical feasibility). This means that amounts attributed to development only reflect a part of the total expenditure on development, which may only include costs incurred just prior to the commercialisation of the item in question. Furthermore, the research/development split can be criticised as effectively being a free-choice, as demonstrated by experience with a similar split in the US accounting for software (see SFAS 86 *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*). In concept, a dollar spent immediately prior to 'technical feasibility' does not form any less a part of the cost of an asset than a dollar spent immediately after. The difference between the requirements in IAS 16 and IAS 38 also raises the prospect of arbitrage between the two Standards in relation to items that potentially bridge both Standards, such as computer software; and

(ii) the recognition of intangible assets acquired in a business combination. This leads to a lack of comparability across entities. Furthermore, prescribed non-recognition of internally generated intangible assets may encourage entities to 'contrive' transactions to facilitate the recognition of intangible assets or transact in a way that avoids recognition. We acknowledge that a retort to this argument is that no intangible assets should be separately recognised, whether or not acquired in a business combination, and instead should be the subject of disclosure rather than recognition. However, adopting this view would be inconsistent with IFRS 3 and would exacerbate concerns about the balance sheet not recognising certain assets.

(d) After initial recognition, IAS 38 requires an entity to carry an intangible asset at cost or fair value, but only allows fair value when it can be determined by reference to an active market. As indicated in paragraph 78 of IAS 38, it is uncommon for active markets to exist for intangible assets. Depending on how the terms 'uncommon' and 'active' are interpreted, often a significant proportion of the current value of intangible assets cannot be recognised. The 'active market' limitation on revaluations imposed by IAS 38 is inconsistent with the treatment of other assets, such as property, plant and equipment, biological assets, investment property and financial instruments and, more

generally, contemporary accounting thought. For example, it is inconsistent with the principles in IFRS 3 on fair value, which impose fair value measurement (albeit as deemed cost) on initial recognition of intangible assets acquired in a business combination, even in the absence of an active market. Furthermore, it is inconsistent with SFAS 157 *Fair Value Measurements*, which, although it does not impose fair value measurement on intangible assets, specifies the manner in which fair value is to be determined where fair value is adopted as the measurement basis, even in the absence of an active market.

(e) Even where IAS 38 allows revaluations to be recognised, the gains or losses are generally required to be recognised in, and remain in, equity. To the extent there is a related/matching liability recognised at fair value through profit and loss, there is an accounting mismatch. The adverse consequences of a mismatch have been acknowledged by the experience with IFRIC 3 *Emission Rights* and its withdrawal in June 2005 (see *IASB Update* June 2005). Under IFRIC 3, participation in a ‘cap and trade’ emission rights scheme would have required entities to recognise intangible assets in the form of allowances and a liability in the form of an obligation to deliver allowances equal to emissions that had been made. Allowances were to be measured in accordance with IAS 38 at either cost or fair value with fair value revaluations recognised in equity, whereas emissions liabilities were to be measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* by reference to the market value of the number of allowances required to settle the obligation and any changes in value recognised in profit and loss.

50. Ernst & Young undertook a study[17] that arguably provides some indication of the shortcomings of IAS 38 by identifying the general magnitude of intangible assets that would no longer be able to be recognised in Australia on the adoption of the requirements in IAS 38. The study found that the reported equity for the consumer staples sector was expected to decrease by 22% on transition to IFRS and by 25% in the first IFRS comparative year, due mainly to the derecognition of intangible assets.

17 Ernst & Young (2005), ‘The Impacts of AIFRS on Australian companies: A study of the financial statement disclosures by Australia’s top 100 listed companies’, December 2005.

51. Some regard the requirements in IAS 38 as appropriate. Although we do not support this view, for completeness, we have presented some of the supporting arguments, together with our rebuttals, below.

(a) Some assert that investors would not act differently even if more intangible assets were to be recognised, measured at fair value or subject to greater disclosure requirements. They argue that information about such assets is available from other sources, such as through existing note disclosures or management briefings. In some circumstances, assets and their value are just known to exist, by virtue of the nature of an entity. However, consistent with our conclusion in paragraph 38, management has a comparative advantage in providing information about intangible assets in financial reports and therefore investors could presumably access the information at a lower cost if management were to provide it. Furthermore, although relatively highly sophisticated users may be able to access information to compensate for non-recognition, other users may not be in such a privileged position. As noted by Lev (1980), such inequalities of access to information can undermine the efficiency of capital markets.[18]

(b) The costs of identifying, auditing and measuring intangible assets under the current standard are acceptable from a cost/benefit perspective. Making the requirements more onerous would unduly increase audit and compliance costs. However, although audit and other costs may be relatively low under the current regime, so too are the benefits provided from the resulting lack of information. An analysis of costs and benefits is provided in paragraphs 63 to 71.

(c) An alternative to the current requirements in IAS 38, depending on the project's scope and objective, would result in the recognition of certain internally generated intangible assets that arise from the day-to-day operations of an entity and are therefore not developed through a discrete plan. Some express the view that these types of assets should not be recognised due to the absence of an attributable discrete and separable transaction to trigger their initial recognition or signify control. Furthermore, some are concerned that

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18 Lev, B. (1980), 'Toward a theory of equitable and efficient accounting policy', *The Accounting Review*, Volume 63, pp. 1-22.

the absence of a transaction means that there is no purchase price to which the measurement can be benchmarked. However, we note that the *Framework* does not identify the absence of an attributable transaction as a justification for non-recognition of an asset.

(d) IAS 38 requirements minimise the subjectivity involved in accounting for intangible assets. The alternative level of subjectivity that would be involved in identifying, recognising and measuring intangible assets if a fair value measurement basis were to be adopted, particularly in the absence of a separate transaction, a business combination, or an active market, could expose financial reporting to a high degree of manipulation. However, we note that it would be difficult, if not impossible, to write an accounting standard that prevents the manipulation of accounting numbers.

(e) Some maintain that there are insurmountable difficulties in reliably measuring intangible assets, whether at cost or fair value, except in the circumstances specified in IAS 38. In response, we note that:

(i) IFRS 3 requires the perceived difficulties in reliably measuring intangible assets (acquired in a business combination) at fair value, at least as at the date of a business combination, to be overcome;

(ii) concerns about measurement should be alleviated with the advent of greater consistency in the valuations. Some argue that fair value measurement should not be contemplated until greater consistency is achieved. However, the imposition of measurement requirements may itself facilitate greater consistency as the requirements lead to a focus on developing credible techniques. Such developments are emerging, as is evident from the activities of the FASB, American Institute of Certified Public Accountants (AICPA) and International Valuation Standards Committee (IVSC). For example:

A in June 2007 the AICPA issued Statement on Standards for Valuation Services No. 1 *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*;

B the FASB has issued Invitation to Comment *Valuation Guidance for Financial Reporting* (15 January 2007), seeking comments from constituents on the need for, the nature of and the responsibility for developing guidance on valuation; and

C the IVSC has established a team of experts (comprising valuation and accounting experts) to draft a valuation standard and implementation guidance to address measuring the fair value of intangible assets, such as brands, licences, patents, know-how, customer contracts and customer relationships.[19] As a first step, in July 2007 the IVSC released a Discussion Paper *Determination of Fair Value of Intangible Assets for IFRS Reporting Purposes* for comment by 31 October 2007.

In any event, there is precedent for adopting principle-based requirements ahead of developments in implementation guidance. For example, the IASB is advocating use of market value margins in its Insurance Contracts project, but does not yet know how they will be determined – potentially leaving it to actuaries to develop appropriate techniques.

Conclusion on Criterion 2

52. The principles in IAS 38 (first issued in 1998) can be traced back to Exposure Draft 9 International Accounting Standard Proposed Statement – *Accounting for Research and Development Costs*, which was issued for comment on 1 February 1977. Significant developments in accounting thought have occurred since then. Our view is that IAS 38 is considerably out of date and the information it generates does not appropriately reflect economic conditions or results. We conclude that the existing guidance available is in need of review.

53. Our view is, and comments by IASB and FASB members appear to support this view, that minor amendments to IAS 38 would not be sufficient to adequately address the deficiencies identified in the current requirements. Consequently, consistent with paragraph 7, one, some or all aspects of IAS 38 should be fundamentally reviewed. The range of that review is considered under Criterion 4 *the quality of standards to be developed.*

19 IVSC *E-News*, Issue 9, January 2007 and Issue 16, August 2007.

Criterion 3: The possibility of increasing convergence

54. The current requirements of national standard setters that have not adopted IFRSs differ from those in IAS 38. For example, some (US, Japan) require development costs to be expensed as incurred whereas IAS 38 requires some development costs to be capitalised. There are also differences in detail, such as the definitions of research and development, that lead to differences in accounting outcomes. Given the significance of intangible assets to many entities, these differences can give rise to substantial differences in the financial reporting outcomes amongst entities across these jurisdictions.

55. There will be some convergence benefits from the project to the extent current national requirements are diverse and the improvements to IAS 38 would contribute to jurisdictions being willing to adopt IFRSs. Discussions held at the September 2006 National Standard Setters meeting indicate that there is widespread, although not unanimous, agreement that a revision of the requirements in IAS 38 would be appropriate. Also, albeit with less support, there was some agreement with the basic principles that might underlie the new approach.

56. A less ambitious convergence project that would focus on merely removing convergence differences between FASB and IASB would also facilitate convergence. However, it would not achieve the improvements contemplated in this proposal, even under the least ambitious project included in paragraph 7.

Joint project with the FASB

57. In order to continue making progress toward convergence, we think that any final standard should be developed jointly with the FASB. We therefore propose that, subject to approval by the IASB and FASB, the project should be a joint project. Given the importance of intangible assets, we would not advocate an IASB-only project.

Conclusion on criterion 3

58. We conclude that there is a good prospect that an Intangible Assets project will gain support from national standard setters and regulators. Furthermore, conducting the project as an IASB/FASB joint project has the potential to facilitate convergence with respect to the accounting for intangible assets.

Criterion 4: The quality of standards to be developed

Cross-cutting issues

59. To varying degrees, depending on the scope and objective of an Intangible Assets project, many of the issues that would arise are closely related to issues in other projects. Those identified are:

    (a) Definition and identification of assets – finding a technically feasible solution to the issues within the scope of an Intangible Assets project is based on an agreed understanding of the definition of an asset. Identifying the existence of an asset depends on the *Framework* definitions, which are currently under review in the Conceptual Framework project. We suggest that the analysis of intangible assets, including consideration of which intangible items meet the definition of an asset, be based on the Boards' most recent thinking about the asset definition, including the unit of account. This would provide an appropriate basis for considering, for example, whether costs incurred in pursuing opportunities or whether knowledge gained along the way provides a right or privileged access that meets the asset definition. Given that the Conceptual Framework project will itself involve research related to intangible assets, this seems to be the most efficient and effective use of the Boards' resources. It would also avoid the need to consider the implications of the differences between the current definitions of assets adopted by the IASB and FASB.

    (b) Recognition criteria – the asset recognition criteria are also being reviewed in the Conceptual Framework project. Like the asset definition, we suggest that the analysis of intangible assets be based on the Boards' most recent thinking about recognition criteria. As noted in (d) below, recognition criteria are interrelated with measurement.

(c) Measurement – the work being done on measurement as part of the Conceptual Framework project and the Fair Value Measurements project is unlikely to be sufficiently advanced at the time of starting the Intangible Assets project to incorporate into this project. Until the conceptual issues are resolved, depending on the objective, this project should include consideration of cost and fair value as alternative measurement bases. We also suggest that the analysis of the measurement of intangible assets be based on the existing, albeit different, definitions and guidance for fair value adopted by IASB and FASB, until the Fair Value Measurements project is finalised.

(d) Business Combinations Phase II project – this project has addressed issues relating to the identification of intangible assets acquired in a business combination and has removed the 'reliably measurable' recognition criterion.

(e) Leasing project – this project, including the definition of lease assets, potentially has implications for the scope of the definition of intangible assets. For example, as mentioned in paragraph 7(b)(iii)B above, a cross cutting issue with the Leasing project is usage rights.

(f) Financial Instruments project – this project raises issues related to core deposit intangibles and similar items.

(g) Insurance project – this project raises issues related to customer relationships. The Insurance Discussion Paper notes that an existing insurance contract is closely associated with the part of the customer relationship that relates to expected policyholder exercise of existing contractual options. The IASB's preliminary view expressed in paragraph 142 of the Discussion Paper is that this close association justifies the recognition of that part of the customer relationship, if appropriate conditions are met. The Discussion Paper also notes that the Board does not intend to extend that conclusion to options in contracts other than insurance contracts.

(h) Revenue Recognition project – this project is adopting an asset and liability model for revenue recognition and is considering two approaches to implementing that model: the fair value approach or the customer consideration approach. If recognition is to be an objective of the Intangible Assets project, the initial recognition of an internally generated intangible asset, for example an order backlog (see paragraph B2 of IFRS 3 Illustrative Examples), would entail the corresponding initial recognition of a credit

amount. Issues include: (i) whether an order generates revenue recognition; and (ii) if it does not, whether it should be recognised as an intangible asset and what the corresponding credit side of the journal entry would be.

(i) Financial Statement Presentation project – this project is addressing issues that are pertinent to the concerns of some users, particularly if recognition is to be the objective of the Intangible Assets project. As noted in paragraph 22 above, some users are concerned that changes in current value estimates would mask operating performance.

(j) Extractive Activities research project – this project is addressing issues analogous to those that need to be addressed for intangible assets. For example, incurring costs in the hope of finding oil is analogous to research. A 'dry hole', in which no economic reserves are found, is analogous to an unsuccessful research project. A 'tight hole', in which the geological findings are kept secret, is analogous to keeping research findings secret. In IFRS 6 *Exploration for and Evaluation of Mineral Resources* (paragraph IN1(c)), the IASB notes that:

> …accounting practices for exploration and evaluation assets under the requirements of other standard-setting bodies are diverse and often differ from practices in other sectors for expenditures that may be considered analogous (eg accounting practices for research and development costs in accordance with IAS 38).

(k) International Financial Reporting Interpretations Committee (IFRIC) projects dealing with intangible assets – for instance:

    (i) IFRIC 12 *Service Concession Arrangements* (issued November 2006) addresses service concession arrangements that require the operator of a service concession arrangement to recognise a financial asset, an intangible asset or both, depending on the contractual terms of the arrangement. The operator is required to recognise an intangible asset to the extent that it receives a right to charge users of the public service;

    (ii) At its September 2006 meeting, the IFRIC agreed to initiate a project to consider when costs incurred for advertising and promotional activities (including catalogues) may be carried forward in the balance sheet. The project considered at what point an expense should be recognised in the situation where an entity incurs expenditure on advertising or promotional material before the reporting date but the

material is distributed after the reporting date. The IFRIC agreed that, between the time that an entity receives goods or services and the time at which it first uses them, the entity has an asset in the right to use those goods or services. The IFRIC consequently proposed amendments to paragraph 70 of IAS 38 and SIC Interpretation 32 and agreed that they be presented to the IASB with a request that they be addressed as part of the Board's annual improvements process[20] *[Further input to be incorporated prior to December IASB meeting.]*;

(iii) Paragraph BC22 of IFRIC Interpretation 13 *Customer Loyalty Programmes* (June 2007) states that: "Customer loyalty programmes may create or enhance customer relationship intangible assets"; and

(iv) SIC Interpretation 32 *Intangible Assets – Web Site Costs* requires that a web site that arises from development and is for internal or external access is an internally generated intangible asset that is subject to the requirements in IAS 38.

60. Being aware of these cross-cutting issues should ensure that the Intangible Assets project is developed in a way that is consistent with other current projects.

61. Some argue that an Intangible Assets project, particularly one with a recognition objective, should not commence until the Conceptual Framework is further advanced. We note the FASB's comments in paragraph 4 of FAS 19 *Financial Accounting and Reporting by Oil and Gas Producing Companies* that: "any decision on applying value accounting to oil and gas companies should await resolution of the broader issue of the general applicability of value accounting in the Board's project, "Conceptual Framework for Financial Accounting and Reporting."" Furthermore, some argue that recognition should not be contemplated until measurement under IFRS 3 gains greater credibility (such as through the efforts of the IVSC, see paragraph 51(e)(ii)C).

20 *IFRIC Update*, March 2007, p.3.

62. We conclude, however, that it is reasonable to assume that the cross-cutting issues will not prevent a technically feasible solution being identified and developed. This is because:

 (a) in relation to definitional issues, there is significant overlap between the current definition and the emerging definition of an asset. Therefore definitional issues do not provide a justification for delaying commencement of work;

 (b) by the time the project is initiated or during its implementation, progress on related projects either will be sufficiently advanced to inform the intangible asset debate, or we will find that completion of the other projects is not necessary. Although it would be advantageous for those other projects to be completed, our view is that the significance of the intangible assets issues means that it is more important to pursue a timely solution than to wait for the other projects to be completed; and

 (c) given the nature of accounting standard setting, most projects are interrelated and overlap with other projects. We do not think that it is necessary to treat the Intangible Assets project as exceptional and delay its progress while other projects that are similarly impacted upon by concurrent projects are continuing. Both Boards have recognised that it is not practical to stop other standard-setting activities while the conceptual framework is being developed.

Analysis of costs and benefits

63. Generally speaking, new reporting requirements impose costs on preparers and provide benefits to users. The relative costs and benefits may vary depending on the nature of any new accounting model that might be adopted. For example, the costs and benefits that would arise from a recognition model would depend on the types of intangible assets that would be recognised and their basis of measurement. Furthermore, if a disclosure-only model is adopted, costs and benefits would depend on the information to be disclosed, and may be less than a recognition model to the extent that the rigour in determining the information to be disclosed is less than that which might be applied for recognition. As noted in paragraph 26, research has found that disclosed measurements may not be prepared with the same level of robustness as recognised amounts. Accordingly, the benefits to users would be diminished to the

extent users cannot rely on information disclosed in notes to the same extent as recognised information.

64. A new accounting model that requires greater recognition and/or disclosures of intangible assets will impose implementation costs as well as higher on-going costs on preparers than the current model. For instance, a new accounting model that requires the recognition and/or disclosure of more internally generated intangible assets may impose significant one-off systems costs as well as additional on-going costs in relation to the collection, management and audit of information necessary to comply with the new requirements. Additional costs would also be imposed on complying entities if the new accounting model mandated subsequent recognition or disclosure of revaluations for some or all intangible assets.

65. Accurately quantifying the costs of implementing a new accounting model for intangible assets is difficult. Nevertheless, the implementation costs reported by entities that have adopted IFRS 3, which requires the identification and initial fair value measurement of intangible assets acquired in a business combination, arguably provides some indication of the level of costs that entities may incur in identifying and measuring internally generated intangible assets for the purpose of first time recognition. A survey of the financial reports of 88 companies in the FTSE 100 that filed in the first year of IFRS up until March 2006, conducted by Intangible Business Ltd, found that approximately £80 million had been spent on specialist skills in relation to the implementation of IFRS 3.[21]

66. These costs, however, are not a definitive measure. The true costs may be lower. For example, the identification and recognition of acquired intangible assets is only one of a number of new requirements prescribed by IFRS 3 that would have required specialist skills to implement. Also, £80 million is not the incremental cost relating to intangible assets since costs would be incurred in a business combination in measuring tangible assets and complying with the other requirements of the Standard. On the other hand, the true costs may be higher. For example, reported specialists

21 Intangible Business Ltd is an independent brand valuation consultancy. It has published a report 'IFRS 3: The First Year – The FTSE 100's reporting of acquired intangible assets.' (www.intangiblebusiness.com).

costs presumably exclude internal resources, such as management time, utilised in the implementation process. Furthermore, generalising from the £80 million cost to speculate on the costs of identifying and measuring internally generated intangible assets may not be valid. Incremental costs may be low when measuring the value of intangible assets acquired in a business combination given the need for the acquirer to determine the price it is willing to pay for all of the acquiree's assets, including the acquiree's intangible assets. In contrast, the measurement of the value of certain internally generated intangible assets may only be viable, and therefore cost-effective, at the time an entity undertakes a periodic review and assessment of whether a project should continue or be abandoned.

67. The costs of implementing a new accounting model for intangible assets might not be significant for those entities that have already identified and are managing intangible assets for internal management purposes, or have gained relevant experience and already have in place systems as a result of them acquiring intangible assets in a business combination. Moreover, experience suggests that costs would decrease over time as preparers and their advisors become more experienced in the identification, recognition, measurement and/or disclosure of internally generated intangible assets.

68. The benefits of adopting a new accounting model that requires greater recognition and/or disclosures of intangible assets will potentially largely be found by users in terms of financial reports that more clearly reflect the assets of a business. As noted in paragraphs 20, 25, 28 and 29, some users do not believe that they would benefit from greater recognition of intangible assets, but indicate some support for greater disclosure. If requirements were to change, users will need to invest some time and resources into gaining an understanding of the new information being provided. We would expect the cost necessary for users to educate themselves, however, is likely to be mitigated to the extent that any changes in the initial treatment of internally generated intangible assets are similar in principle to the treatment of intangible assets acquired in business combinations and/or internally generated tangible assets. We would also expect that the cost necessary for users to educate themselves about the new requirements would be at least matched by the benefits provided by the resulting information.

69. Removing the current limitations on the types of internally generated intangible assets that entities are permitted or required to recognise and/or expanding the current disclosure requirements may also provide benefits to preparers of financial reports. We would expect that requiring the recognition and/or disclosure of more internally generated intangible assets and allowing or requiring subsequent revaluation by way of recognition or disclosure would be beneficial to entities with significant internally generated intangible assets. For example, requiring the recognition of internally generated intangible assets would improve comparability between entities that grow 'organically' and those that grow by acquisition. In other words, by not recognising many internally generated intangible assets, entities that grow organically may be experiencing, for instance, relatively high costs of debt and systematic undervaluation compared with entities that grow by acquisition. These organically growing entities are often less capable of dealing with relatively high costs of debt and systematic undervaluation because strategies to develop intangible assets internally, rather than through acquisition, are often characteristics of entities that are, for instance, relatively young and have limited access to external finance.[22]

70. Changing the initial treatment of internally generated intangible assets to be more consistent with the treatment of intangible assets acquired in business combinations would be beneficial to entities that acquire or are contemplating acquiring other businesses. For instance, if acquirees were to recognise internally generated intangible assets, the accounting for business combinations by acquirers would be simplified. This would reduce the cost of identifying and measuring the acquired intangible assets and would increase the information available to the acquirer with regard to negotiating the deal and performing due diligence. Presumably, an acquiree knows more about its internally generated intangible assets than the acquirer, particularly if the business combination is 'hostile'.

71. Consistent with the discussion under Criterion 3 *the possibility of increasing convergence*, removal of the existing differences between different national standards and IFRSs will increase comparability and reduce the need for users to make

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22 Lev (2001), pages 93 to 96.

estimated adjustments in analysing entities in different jurisdictions. In addition, this would reduce costs for entities reporting under more than one GAAP.

Conclusion on criterion 4

72. As noted in paragraph 7, we think that any of the potential projects with a scope and objective identified in paragraph 7 would lead to some improvements to current requirements and contribute to satisfaction of users' needs. The further along the paragraph 7 spectrum of scopes and objectives, the greater the improvement, but the more difficult it would be for the Boards to achieve.

73. Although it is necessarily a subjective assessment, on balance, we are persuaded that the expected benefits of improved financial reporting will exceed the costs, irrespective of the project's scope and objective.

Criterion 5: Resource constraints

74. If a joint IASB and FASB project is approved, given the importance of the project, we think that it should be conducted by a joint project team comprising IASB staff and FASB staff.

75. To provide an indication of resource requirements, we have provided an estimate for each of the possible projects identified in paragraph 7. To the extent the Boards decide to undertake an even more narrowly scoped project, the resource requirements would be correspondingly less.

76. We estimate the following IASB and FASB resource requirements (excluding 'indirect' time such as reviews by more senior staff and Board members):

	Disclosure-only project, as outlined in Appendix 3 (see also paragraph 7(a))	Address major shortcomings of IAS 38 (see paragraph 7(b))	Recognition of intangible assets developed from a discrete plan (see paragraph 7(c))	Comprehensive recognition project, as outlined in Appendix 2 (see also paragraph 7(d))
Senior Project Director	50%	75%	75%	100%
Senior Project Director	25%	50%	50%	75%
Project Manager	25%	25%	25%	75%
Assistant Project Manager	50%	50%	50%	100%
Estimated time frame	2 years to develop an Exposure Draft	2 years to develop an Exposure Draft	2 years to develop a Discussion Paper	4 years to develop a Discussion Paper

77. Board Advisors (both IASB and FASB) should also be closely involved. In addition to IASB and FASB resources, consideration should be given to involving members of staff from other interested accounting standard setters.

78. Resources planned to be initially allocated are expected to be sufficient in the early stages of the project, but additional resources might be necessary as it develops, particularly if extensive research or field testing is required. However, the work performed to-date as part of the development of this project proposal, the work undertaken as part of an earlier more comprehensive research proposal, and the FASB work on its Disclosures About Intangible Assets project provide a basis for undertaking the research that will be required without the need to start afresh.

79. Further discussion of resource constraints is in the cover memorandum to the agenda proposal session of the SAC meeting.

OVERALL CONCLUSION ON SCOPE AND OBJECTIVE

80. If resources are available, our preference is to undertake an Intangible Assets project with:

    (a) a broad scope of initial accounting for intangible assets other than those acquired in a business combination (with a focus on, but not limited to,

internally generated intangible assets) and the subsequent accounting for all intangible assets. This will facilitate the development of consistent principles, irrespective of the manner in which intangible assets arise;

(b) a recognition objective. Such a technical objective would most effectively address the inadequacies in IAS 38 outlined in paragraph 49 of this paper and our concern that disclosure-only is not an ideal substitute for recognition. However, we acknowledge that a disclosure-only objective may be a pragmatic interim solution; and

(c) an unspecified measurement objective, to be specified as part of the project process rather than as part of the agenda decision.

81. We think that measurement issues should be resolved as part of the project process, rather than as part of the agenda decision process, because we do not yet have sufficient information to draw a conclusion. We acknowledge that this increases the 'decision risk' of the project because the Boards could be divided on the issue of requiring cost or fair value, and resolving that difference might prove difficult and time-consuming. However, that risk is in the nature of the Boards' work. We think that either cost or fair value would make a significant contribution to financial reporting.

82. Advice from FASB staff is that, based on experience with previous attempts at addressing intangible assets and analogous issues in the US environment and the resources needed to advance significant projects on the Boards' already full agendas (see Criterion 5), it may be difficult to justify this proposal in the current US environment.

83. We acknowledge that our preferred approach would raise expectations of constituents and only be achievable if sufficient resources are allocated and the project is given due priority by both Boards. If the Boards conclude that resources are not available to undertake such a project now, we would prefer that the project is delayed until resources become available.

84. If the Boards conclude that delaying work on improving the accounting for intangible assets is not appropriate, our next preference is a single comprehensive disclosure-

only project. If such a project is adopted, we think that the short-term IASB/FASB convergence project on research and development should be progressed at the same time.

Decision Aid

85. To provide a structure for the Boards' decision making, we have prepared the following matrix. The shaded cells indicate those aspects (scope and technical objective) of a potential project that we believe should be included. After considering the material in this proposal, each Board member is asked to tick the cells that they conclude should be included within the scope. This will help facilitate discussion at the meeting.

Defining the Scope and Technical Objective of an Intangible Assets Project

		Technical objective of the project					
		Recognition			Disclosure		
		Measurement		Presentation & Disclosure	Qualitative information	Quantitative information	
		Cost	Fair value			Cost	Fair value
Scope of the project	**INITIAL AND SUBSEQUENT ACCOUNTING**						
	A: Internally generated						
	Arising from a discrete plan						
	Research and development (as defined in IAS 38)						
	In process						
	Contractual or other legal rights (eg patents)						
	Proprietary techniques (eg secret formula)						
	Other						
	In process						
	Contractual or other legal rights						
	Proprietary techniques						
	Relationships (eg customer list)						
	Arising other than from a discrete plan						
	Contractual or other legal rights						
	Proprietary techniques						
	Relationships						
	B: Separately acquired, including those acquired in exchange for a non-monetary asset or assets						
	C: Acquired by way of a government grant						
	D: Acquired in a group of assets or net assets that is not a business						
	SUBSEQUENT ACCOUNTING						
	E: Acquired in a business combination						

PROPOSED PROJECT PLAN

86. Given the significance of the possible changes to IAS 38 under a comprehensive recognition-based project, we think it is not appropriate to move directly to an Exposure Draft. Instead, we propose that a Discussion Paper exploring the issues and setting out the preliminary views of the Boards be developed initially. An outline of the issues that might be addressed in the Discussion Paper is provided in Appendix 2.

87. Given the nature of a disclosure-only objective, we think such a project could be satisfied by moving straight to an Exposure Draft. An outline of the issues that might be addressed in the Exposure Draft is provided in Appendix 3.

Working Group

88. Irrespective of the scope or objective of the project, we propose that a Working Group be established so that the Boards and staff can have access to expert advice from constituents. The Working Group should include users, preparers and regulators with practical experience and expertise in relation to identifiable intangible assets. The role of the Working Group would be consultative. Accordingly, the purpose of the Working Group would not be to develop formal recommendations, but would be to act as a forum for the Boards to consult on important decisions, help identify practical and implementation issues and priorities, and provide a means of testing ideas and concepts developed by the Boards and project staff. It would be consulted when and to the extent required. Relevant issues arising from preliminary Board discussions should first be discussed with the Working Group, and then staff proposals together with Working Group comments would be put to the Boards for consideration. This would help ensure the most technically feasible and practical new accounting model is adopted.

Work plan and timetable

89. There are many complex issues for the Boards to discuss before they can form preliminary views. The time necessary for the IASB and FASB to jointly consider issues needs to be taken into account. In addition, the time necessary for discussions

with the Working Group and analysis of their comments should be considered. Work plans and timetables for each potential project ((a) recognition, and (b) disclosure-only) are provided in Appendices 2 and 3 respectively.

APPENDIX 1

IFRS and US GAAP – BRIEF OUTLINE

This Appendix is based on material included in Appendix B of agenda paper 13A of the IASB/FASB joint April 2004 meeting – updated for subsequent developments, including the outcome of the Business Combinations Phase II project.

A1. This Appendix contains an outline of the principal intangible asset recognition requirements in IFRS and US GAAP. IFRS is presented first, followed by the general requirements of US GAAP.

IFRS

A2. The principal requirements for intangible asset recognition under IFRS are set out in IFRS 3 and IAS 38. IFRS applies the same overall recognition principles to all intangible assets regardless of how they arise.

A3. An intangible asset will be recognised under IFRS if: (a) it meets the definition of an intangible asset; (b) it is probable that the expected future economic benefits attributable to the intangible asset will flow to the entity; and (c) the cost of the intangible asset can be measured reliably.

A4. If an intangible asset is acquired, separately, with a group of net assets or in a business combination, the probability of the expected future economic benefits flowing to the entity is presumed. Therefore, an acquired intangible asset will be recognised under IFRS if it meets the definition of an intangible asset and its cost can be reliably measured.

A5. When an intangible asset is internally generated, it is sometimes difficult to assess whether, and when: (a) it meets the definition; (b) it will probably generate expected future economic benefits; and (c) its cost can be measured reliably.

A6. Because of this, IFRS applies some additional recognition criteria to internally generated intangible assets and makes it clear that the recognition of certain others, that may or may not meet the definition, is prohibited.

A7. The creation of an intangible asset that is generated internally must be classified into a research phase and a development phase. If these two phases cannot be distinguished, then it must all be treated as the research phase. Expenditure on research (or on the research phase of an internal project) is recognised as an expense when it is incurred.

A8. An intangible asset arising from development (or from the development phase of an internal project) is recognised if, and only if, an entity can demonstrate that it meets all of six additional recognition criteria. An entity must demonstrate:

(a) how the intangible asset will generate probable future economic benefits;

(b) the ability to measure reliably the expenditure attributable to the intangible asset during its development;

(c) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(d) its intention to complete the intangible asset and use or sell it;

(e) its ability to use or sell the intangible asset; and

(f) the availability of adequate technical, financial, and other resources to complete the development and to use or sell the intangible asset.

A9. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the entity that can be measured reliably at cost. Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance are not recognised as intangible assets because they cannot be distinguished from the cost of developing the business as a whole.

A10. Expenditure on start-up activities (other than property, plant and equipment), training, advertising and promotional activities, and expenditure on relocations or reorganisations are also expensed as incurred. Retrospective capitalization of expenditure that has previously been expensed is not allowed. *[Further input to be incorporated prior to December IASB meeting.]*

US GAAP

A11. The principal requirements for intangible asset recognition under US GAAP are set out in FASB Statements No. 141, Business *Combinations,* and FASB Statement No. 142, *Goodwill and Other Intangible Assets.* US GAAP applies different recognition principles to intangible assets depending on how they are acquired or developed and, in some cases, depending on the nature and use of the particular intangible asset.

A12. An intangible asset acquired in a business combination is recognised separately from goodwill if it meets the definition of an intangible asset and arises either from contractual or legal rights, or it is separable.

A13. Intangible assets acquired separately or with a group of net assets are recognised if they meet the definition of an intangible asset.

A14. US GAAP requires that the costs of internally developing, maintaining, or restoring intangible assets (including goodwill) that: (a) are not separately identifiable; (b) have an indeterminate life; or (c) are inherent in a continuing business and related to an entity as a whole, are expensed when they are incurred.

A15. Unless it is covered by separate specialised guidance, US GAAP does not specify the accounting treatment for an intangible asset that: (a) is separately identifiable; (b) has a determinate life; or (c) is not inherent in a continuing business and related to an entity as a whole.

A16. Specialised guidance in US GAAP applies different recognition criteria to different types of expenditures on internally generated intangible assets and to different industry groups.

A17. For example: research and development costs must be expensed as incurred; some costs of developing computer software, exploring for oil and gas, making films, recording music and creating title plant[23] must be expensed, and some must be capitalised when certain (different) criteria are met. Some of these criteria have common themes, but are not the same.

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23 Paragraph 1 of FAS 61 *Accounting for Title Plant* states: "In summary, a title plant constitutes a historical record of all matters affecting title to parcels of land in a particular geographic area.

APPENDIX 2

A COMPREHENSIVE RECOGNITION AND MEASUREMENT PROJECT

OUTLINE OF ISSUES

B1. The project needs to address a range of issues, including:

(a) the definition of assets and the nature of intangible assets. For example, Lev (2001) observes that 'partial excludability' is a feature of many intangible assets. He states:

> The well-defined property rights of physical and financial assets enable owners to effectively exclude others from enjoying the benefits of these assets. … In the case of intangible investments, however, nonowners can rarely be precluded from enjoying some of the benefits of the investments. (page 33);

(b) the kinds of rights intangible assets provide;

(c) the cross-cutting issues referred to in paragraph 59 of the project proposal; and

(d) recognition, measurement, presentation and disclosure.

B2. The issues could be presented in a Discussion Paper structured into two sections:

Section 1: Initial Accounting for Intangible Assets other than those Acquired in a Business Combination (with particular emphasis on internally generated intangible assets); and

Section 2: Subsequent Accounting for all Intangible Assets.

Section 1 should be developed before Section 2, but issues raised in consideration of Section 2 may lead to amendments to the preliminary conclusions reached in Section 1.

Section 1 Initial Accounting for Intangible Assets other than those Acquired in a Business Combination (with particular emphasis on internally generated intangible assets)

B3. Section 1 should focus on definition/identification, recognition, measurement and presentation/disclosure issues relating to internally generated intangible assets. This should involve the analysis of the following models:

(a) a recognition and fair value measurement model based on the principles for the initial accounting for intangible assets acquired in a business combination with supplementary disclosures;

(b) a recognition and cost measurement model based on the principles for the initial accounting for internally generated tangible assets (for example, those contained in IAS 16) with supplementary disclosures; and

(c) a recognition and mixed-measurement model whereby cost is adopted for internally generated intangible assets developed under a discrete plan and fair value is adopted for the other group of internally generated intangible assets.

Consideration of how these different models might overcome the current information deficiencies and meet users' needs, and the implications for preparers, should also be undertaken.

B4. The work relating to the model referred to in paragraph B3(a) should particularly focus on, as a working hypothesis, extending the principles reflected in IFRS 3 for intangible assets acquired in a business combination to the same types of intangible assets that are internally generated. However, the project should not be seen as an extension of the Business Combinations project. An alternative approach would be to address the issues from the *Framework* perspective. Conceivably that would encompass a broader range of intangible assets than IFRS 3, because IFRS 3 limits the range by specifying the identifiability criterion in the definition of an intangible asset (see, for example, paragraph B165 of SFAS 141, which notes that the identifiability criterion scopes out "customer service capability, presence in geographic markets or locations, nonunion status or strong labor relations, ongoing training or recruiting programs, outstanding credit ratings and access to capital markets, and favorable government relations"). However, because IFRS 3 reflects recent thinking of the Boards, it provides a more suitable practical basis for the working hypothesis. In our view, the advantages of this approach outweigh the disappointment to advocates of recognition of, or disclosure about, for example, knowledge capital, ecological attitudes, and other non-contractual, non-separable intangible assets.

B5. The assessment of the working hypothesis should be aimed at identifying any impediments to extending the IFRS 3 principles to internally generated intangible assets. The assessment should therefore include consideration of:

(a) the difficulties of identification associated with intangible assets. This may lead to conclusions about the suitability of adopting IFRS 3's notions of separability and legal rights (that is, identifiability) as a basis for identification and recognition of internally generated intangible assets;

(b) whether there is a fundamental difference between a transaction that is a business combination and a transaction or other event that gives rise to internally generated intangible assets that warrants a different accounting treatment. For example:

    (i) goodwill is typically recognised in a business combination but is not recognised in the context of other transactions or events. A consequence is that, if internally generated intangible assets were to be recognised, their recognition would affect income. In contrast, typically in a business combination, acquired intangible assets are effectively recognised by allocating the purchase consideration and reducing what would otherwise be recognised as goodwill and therefore do not affect income or, at least, not in the same time scale; and

    (ii) in a business combination, a business valuation is generally available against which a cross-check of the recognised amounts of the individual assets, including intangible assets, can be made;

(c) whether IFRS 3 implementation experience provides a basis for applying the principles in IFRS 3 to the initial accounting for internally generated intangible assets. There is limited research to date on implementation experience with IFRS 3:

    (i) Intangible Business Ltd is critical of the way entities applied IFRS 3 in the initial year of implementation of IFRS 3, stating that:

    > the spirit of IFRS 3 is not being followed … accounting for business acquisitions is still opaque and creative accounting is still occurring … intangible assets have been reported at under values (page 5).

    Its report speculates on the reasons for inadequate reporting under IFRS 3, noting the incentives managements have to minimise the

values of intangible assets and maximise goodwill due to amortisation and impairment implications and the lack of specialist skills to implement IFRS 3;

(ii) In contrast, a study undertaken by Mintchik (2006) on the initial year of implementation experience of SFAS 141 concludes that SFAS 141 was effective in achieving greater transparency of financial reporting after mergers. The study states that the:

> Results provide strong evidence that earnings forecast errors decreased for companies involved in merging and acquisition activity after the adoption of SFAS 141 (page 26).[24]

(iii) PricewaterhouseCoopers (2007) found that:

> None of the respondents uses balance sheet information on acquired intangible assets – for example, customer lists or brands. The majority of interviewees believe that the current allocation of purchase price, required under both IFRS and US GAAP, does not provide useful information. (page 7).

Arguably, some of the disinterest in balance sheet information about intangible assets may be a consequence of consolidated accounts only recognising intangible assets related to specific subsidiaries and it is this 'piecemeal' information that is not adequate for investor needs. For instance, where an acquirer purchases a competitor that holds, for example, brands that compete directly with those of the acquirer, the overall consequences of the business combination may be unclear from the group's financial statements because internally generated brands held by the acquirer are not recognised. Perhaps the availability of information about the intangible assets of the entire group would be more meaningful. However, we acknowledge that the disinterest in balance sheet information may instead arise from apprehension about the credibility of recognised amounts; and

(iv) Canadian UAC members provided us with comments on their experience with the Canadian Standard, CICA 1581 *Business Combinations*, the requirements of which correspond with those of IFRS 3. In general, they expressed a view that the information on

24 Mintchik, N.M. (2006), 'The Effect of SFAS No. 141 on the Transparency of Business Combination Reporting: Evidence from the Initial Year of Implementation', *Working Paper*, University of Missouri at St. Louis, (March 2006). The paper goes on to note that the improvement in financial reporting transparency more likely follows from the extended disclosure requirements and the other required changes in purchase method rather than from the elimination of the pooling of interests method.

intangible assets acquired in business combinations being provided by acquirers in accordance with CICA 1581 is useful for decision-making, although additional supplementary disclosures would enhance the information currently being provided. The majority expressed doubt about whether CICA 1581 is being applied as it was originally intended. Some view this as being due to the difficulty of reliable measurement, resulting in intangible assets not being separately recognised. They expressed a view that intangible assets that are difficult to quantify and measure are not being separately identified and are being included in goodwill. A venture capitalist suggested that, under the current requirements, entities have an incentive to include finite life intangible assets with goodwill in order to avoid amortisation. Others noted that intangible assets are being separately recognised but at an amount less than fair value. Some of the users surveyed accept the manner in which CICA 1581 is being applied on the basis that intangible assets are generally not material in comparison with total assets. An investor noted that, from a financial statement analysis perspective, many analysts view goodwill and intangibles as similar.

Further research into implementation issues identified by preparers, and how they might be addressed, should also be undertaken as part of the project.

B6. The work relating to the model referred to in paragraph B3(b) above of adopting the principles applicable to internally generated tangible assets should include consideration of the fact that internally generated tangible assets are easier to identify than internally generated intangible assets. This will have a bearing on deriving a feasible solution.

B7. In relation to the measurement basis to be adopted, consideration should be given to the definition of cost in the context of intangible assets and whether it is more or less difficult to determine reliably than a measurement at fair value. Consideration should also be given to whether different types of intangible assets should be subject to different measurement requirements. Furthermore, supplementary disclosures to

facilitate users' assessments of the veracity of managements' assessments of value should be considered.

B8. Once conclusions are drawn for the initial accounting for internally generated intangible assets, the discussion paper should consider the implications of those conclusions for current requirements for the initial accounting for intangible assets acquired separately, including those acquired in exchange for a non-monetary asset or assets; acquired by way of a government grant; and acquired in a group of assets or net assets that is not a business.

Section 2 Subsequent Accounting for all Intangible Assets

B9. Section 2 should consider subsequent accounting issues in light of and consistent with the conclusions reached in Section 1, in the context of the Conceptual Framework project and the current requirements for the subsequent accounting for tangible assets, under both a cost-based model and a fair value-based model. This includes consideration of:

(a) indefinite life intangible assets (including impairment issues);

(b) finite life intangible assets (including amortisation [useful life, residual value, pattern of use] and impairment issues);

(c) under a cost model, the appropriateness of using previously expensed costs as a basis for measuring an asset;

(d) revaluations (including the implications of recognising revaluations in equity and the notion of recycling); and

(e) presentation/disclosure.

PROJECT PLAN AND TIMETABLE

B9. We propose the following timetable for the project [*pending an assessment of resource constraints; see cover memorandum to the agenda proposal session*]:

Agenda decision	Board meeting December 2007
Section 1: Initial accounting for intangible assets other than those acquired in a business combination	Nine Board meetings Working Group consultation as required
Section 2: Subsequent accounting for all intangible assets	Six Board meetings Working Group consultation as required
Combined Sections 1 and 2	Two Board meetings
Issue of Discussion Paper	2011

The meetings identified in the above table are the key meetings we envisage taking place. Given the scope of the project, there may need to be several additional Board meeting discussions to discuss specific topics within a section. As a joint project, we suggest that the IASB and FASB discuss the same issues (based on the same staff papers) at approximately the same time.

B10. Board Advisors should review papers in advance of Board and Working Group meetings. Following the Boards' discussions of each section, the full draft of the proposed paper should be considered, and if necessary additional Board meeting time allocated.

B11. We propose that the Working Group would meet as and when required. Consistent with the manner in which working groups have been utilised in the past in relation to other projects, we expect that, where appropriate, staff would convene meetings of the Working Group to assist in the development of proposals prior to key Board meetings.

B12. The final Board discussion on Section 1 would be followed by a pre-ballot draft of that section of the Discussion Paper. Section 1 would be subject to amendment depending on the outcome of Section 2 (see paragraph B2 above).

B13. In developing the timetable, we have assumed that no delays will arise, that convenient dates for Working Group meetings can be found, and that Board discussions reach conclusions within the meetings planned for each group of issues.

We have not estimated the timing of an Exposure Draft or a Standard given the length of time before the Discussion Paper is anticipated to be completed.

[*To be completed prior to December IASB meeting*.]

	2008												2009												2010												2011											
	J	F	M	A	M	J	J	A	S	O	N	D	J	F	M	A	M	J	J	A	S	O	N	D	J	F	M	A	M	J	J	A	S	O	N	D	J	F	M	A	M	J	J	A	S	O	N	D
Working Group meetings			*																																													
Key Board meetings																																																
Board Advisors**																																																
Sections:																																																
Initial internally generated																																																
Subsequent																																																
Final Discussion Paper																																																

Key to events for each section of the project:

S – Completion of first staff draft
A – Staff draft discussed at Board Advisors' meeting
B – Key Board discussion (IASB and FASB)
W – Working Group discussion
M – Final milestone (pre-ballot) draft
* Working Group – deadline for applying February, membership approved March

** and staff consultants

APPENDIX 3

A DISCLOSURE-ONLY PROJECT

BRIEF BACKGROUND TO THE FASB's DISCONTINUED PROJECT ON DISCLOSURES ABOUT INTANGIBLE ASSETS[25]

[Paragraphs C1 to C10 are a description of the FASB's deliberations in relation to its discontinued project on disclosures about intangible assets based on AASB staff understanding of material available on the FASB website. To be updated prior to December IASB meeting.]

C1. In August 2001, the FASB circulated for public comment a proposal for a potential project on the disclosure of information about intangible assets that are not recognised in statements of financial position, but would be recognised if acquired either separately or in a business combination. The proposed scope of the potential project included in-process research and development assets that, under FASB Interpretation No.4, *Applicability of FASB Statement No.2 to Business Combinations Accounted for by the Purchase Method*, are recognized as an expense on the date they are acquired.

C2. The FASB received sixty-one comment letters on the proposal. The majority of respondents supported the FASB adding the project to its agenda on the basis that information regarding intangible assets is important for users and sufficient information about them is unavailable. Opposition to the proposal was most significant among preparers and industry association groups who argued that entities should not be required to disclose information about unrecognised intangible assets due to concerns about reliably measuring such assets and sharing proprietary information.

C3. At its 26 October 2001 meeting, the FASB considered the comments received from constituents. The FASB agreed that staff should further develop the potential project by conducting more research, summarising the existing academic research on the topic, and refining the proposed scope of the potential project.

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[25] This brief background has been prepared on the basis of information provided in the FASB's Project Update – Disclosures About Intangible Assets (dated 21 May 2004) and the minutes and Action Alerts to the relevant FASB meetings (www.fasb.org).

C4. At its 9 January 2002 meeting, the FASB discussed the findings of the academic research regarding intangible assets and plans for and resources needed to carry out the proposed project (see, for example, an extract from a FASB memorandum considered at the 9 January 2002 meeting included at the end of this Appendix). The FASB decided:

(a) to add to its technical agenda a project on disclosure about intangible assets that are currently not recognised in financial statements but would have been recognised if acquired, either separately or in a business combination, including acquired in-process research and development; and

(b) that the project should include consideration of whether to require disclosures of quantitative information – values of intangible assets or costs incurred in generating them – as well as qualitative information.

C5. At its 20 February 2002 meeting, the FASB confirmed the initial scope it had agreed on at its 9 January 2002 meeting, with one refinement – that the project should cover disclosures about intangible assets that are currently not recognised in financial statements but would have been if acquired in a business combination under SFAS 141 *Business Combinations*. As a consequence, the project would cover acquired and internally generated in-process research and development but exclude an assembled workforce and other intangible assets that are neither based on contractual or other legal rights nor separable from the entity. The FASB also decided that the qualitative and quantitative information still to be determined in later FASB meetings should be reported for classes determined as in SFAS 142 *Goodwill and Other Intangible Assets.* SFAS 142 requires disclosures about recognised intangible assets subdivided by intangible asset class, defined therein as: "a group of intangible assets that are similar either by their nature or by their use in the operations of an entity". Consequently, the scope of the project would also possibly include recognised intangible assets to the extent that the disclosures require fair values or other information different from the disclosures required in SFAS 141 and SFAS 142. The FASB also decided to work towards required rather than voluntary disclosures.

C6. At its 27 February 2002 meeting, the FASB began considering whether to require quantitative disclosures about intangible assets and, if so, what kind of quantitative

disclosures. The FASB considered several fair-value-based and cost-based approaches to disclosing quantitative information. Pending additional information, the FASB decided that the project's focus should be on the following fair-value-based and cost-based quantitative approaches:

(a) disclosure of the fair values of all intangible assets (both recognised and unrecognised) that fall within the scope at the end of the current year(s); and

(b) disclosure of expenditures in the current year(s) without distinguishing between successful and unsuccessful efforts.

The FASB directed staff to gather additional information from constituents about the aforementioned approaches before making a final decision about quantitative disclosures.

C7. At its 17 April 2002 meeting, the FASB continued its consideration of quantitative disclosures. The FASB reconsidered the two approaches it had agreed to at its 27 February 2002 meeting in light of additional information gathered since that meeting. After discussing those approaches and other aspects of the project, the FASB directed staff to focus its efforts on the development of proposed qualitative disclosures while continuing to gather information about proposed quantitative disclosures.

C8. On 28 August 2002, an education session was presented to the FASB by representatives of The Financial Valuation Group and Phillips Hitchner. Among the topics discussed were some of the alternative methods of measuring of intangible assets.

C9. On 5 September 2002, the FASB met with valuation professionals and other constituents and discussed issues that would arise if the FASB were to require the disclosure of the fair values of intangible assets. The participants discussed:

(a) insights gained from identifying and estimating the fair values of purchased intangible assets for purposes of recognition in financial statements in accordance with SFAS 141; and

(b) the perceived costs and benefits of disclosing the fair values of all of an entity's intangible assets.

The meeting was for information purposes only and the FASB made no decisions in relation to disclosures about intangible assets.

C10. At its 14 January 2004 meeting, the FASB decided to remove from its agenda the project on disclosures about intangible assets. Whilst acknowledging the importance of the reporting issues that would be addressed by this project, the FASB agreed that the nature and timing of such a project should be considered in the context of its plans for a coordinated agenda with the IASB.