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FRC ARP Staff Research Report: Investor Views on Intangible Assets and their Amortisation

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1. Objective, Summary Findings and Conclusions

1.1 Intangible assets have always been an important part of how businesses create value. Licences, patents and trademarks, and computer software are all recognised by companies and their investors as assets that, although lacking in physical substance, are vital to the generation of revenue.

1.2 In recognition of this fact, accounting standard setters have issued standards to address the accounting for such assets. In the UK for example, the Accounting Standards Board (ASB) issued FRS 10 *Goodwill and Intangible Assets* as far back as 1997 to address this very issue.

1.3 In 1998, the International Standards Accounting Committee (IASC) issued IAS 38 *Intangible Assets*. This was revised in 2004 and 2008 when the IASB issued and revised IFRS 3 *Business Combinations.* Under the latest revisions, it is assumed that all intangible assets acquired in a business combination will probably yield economic benefits and can be reliably measured, therefore they must be recognised. This has led to a larger number of intangible assets being recognised on business combinations, including assets such as customer lists and brands that are not usually recognised if internally generated.

1.4 However, controversy continues to surround the accounting for intangible assets, with some investors raising concerns about their separate recognition and subsequent measurement. This paper reports the results of a research project carried out by the Accounting and Reporting Policy team of the FRC to understand investor views on whether, from their perspective, the current requirements in IFRS produce useful and reliable information.

1.5 The research is not intended to cover all views on the accounting for intangible assets, concentrating as it does on those of investors. Furthermore, it shows that such investors do not have homogenous views from which self-evident conclusions can be drawn.

1.6 However, it does highlight a significant level of concern with the accounting for intangible assets amongst a number of investors. Some of these concerns arise from disagreement with the requirements of accounting standards whilst others appear to reflect dissatisfaction with the application of those standards, particularly in respect of disclosures.

1.7 This research is not intended to identify solutions to address these concerns. Rather it is intended to capture investors' views for the IASB to consider in identifying areas for further analysis and investigation. It is also relevant to

preparers as it highlights areas of potential improvement in communication with investors within the current frameworks.

1.8 The following paragraphs summarise the findings of the research. Where percentages are quoted they are given as a proportion of the entire population unless otherwise stated. For detailed analysis of responses to individual questions see sections 2 – 5 of this report. Details of research methods and timing of the research are included in the appendix to this report.

SUMMARY OF FINDINGS

Intangible assets acquired in a business combination

1.9 More than half of the respondents expressed a preference for accounting treatments in the statement of financial position (52%) and in the income statement (59%) different from those currently required by IAS 38.

1.10 The majority of those preferring a different treatment in the statement of financial position (37% of the total population) explained a distinction they make between different types of intangible asset. The key distinguishing characteristics as explained by these respondents were as follows:

- “wasting” intangible assets – these are separable from the entity, have finite useful lives and lead to identifiable future revenue streams. Examples include wireless spectrum and patents; and
- “organically replaced” intangible assets – investors raise doubts about whether these intangible assets are capable of being separated from the entity, are likely to have reliably determined useful lives, or be a source of future economic benefits that could be distinguished from the business as a whole. They stated that such intangible assets are replenished on an ongoing basis through the marketing and promotional expenditure of the company. Examples of such assets include customer lists and brands.

1.11 Although these investors believe that “wasting” intangible assets should be separately identified and capitalised, they are opposed to the separation of “organically replaced” intangible assets from goodwill.

1.12 Respondents that expressed a preference for an accounting treatment subsequent to initial recognition other than that required by IAS 38 suggested either:

- An accounting treatment that reflected the same distinction as noted above; wasting intangible assets to be amortised over their useful lives but organically replaced intangible assets to be subject to annual impairment reviews rather than periodic amortisation (33% of the total population); or
- All intangible assets acquired in a business combination to be subject to annual impairment reviews rather than periodic amortisation (26% of the total population).

1.13 We note that, in respect of intangible assets acquired in a business combination, IAS 38 does not permit different accounting treatments in response to the characteristics noted by respondents because:

- An intangible asset is considered identifiable if it is separable or it arises from legal or contractual rights;
- The probability recognition criterion (that is, the requirement that, in order to be recognised, it must be probable that the asset will yield economic benefits) is always considered to be satisfied; and
- The reliability measurement criterion is always considered to be met, on the basis that there is sufficient information to enable the asset to be measured reliably.

1.14 A majority of all respondents (74%) also noted that they add back amortisation charges on intangible assets acquired in a business combination when considering Earnings Per Share (EPS) ratios in some or all cases.

Internally generated intangible assets

1.15 A majority of respondents (63%) agreed with the requirement in IAS 38 to capitalise development costs as internally generated intangible assets (for example, software development costs).

1.16 However, 15% of respondents would also prefer that research costs were also capitalised. By contrast, 19% of respondents would prefer that all research and development costs were expensed.

1.17 It is interesting to note that both of these groups indicated similar reasons for their preferences. They noted that it is not clear to them from the disclosures given how the accounting policy is applied in practice – i.e. how research is distinguished from development and how the amounts capitalised have been determined such that they can assess themselves the reliability of that information. Some of those that favoured the retention of current requirements to capitalise only development costs also raised concerns on the quality of disclosures and their usefulness.

1.18 Some of these investors noted that companies did not appear to have a consistent approach to capitalisation of such assets. This uncertainty seems to have perpetuated a lack of trust amongst investors about the reliability of the measurement of internally generated intangible assets.

1.19 It is not clear whether these concerns arise from a failure by preparers to fully comply with the disclosure requirements of IAS 38 (and IAS 1 on accounting policies, judgements and sources of estimation uncertainty), a failure to present disclosures in an easily understandable way or shortcomings in the requirements themselves.

1.20 There were significantly more respondents in favour of the periodic amortisation of internally generated intangible assets (52%) than in favour of the same treatment of those acquired in a business combination (15%). This difference was not explained by respondents though it might reflect the difference in the nature of intangible assets that are, in practice, recognised in the two situations given the significantly higher recognition criteria set for internally generated intangible assets.

Separately acquired intangible assets

1.21 The vast majority of investors (89%) agreed with the capitalisation of separately acquired intangible assets and 56% agreed that annual amortisation was the correct treatment in the income statement.

1.22 Once again, this contrasts with views expressed on intangible assets recognised in a business combination or internally generated. This difference may reflect the nature of intangible assets that are, in practice, usually separately acquired. It may be the case that these tend to be "wasting assets" as described above. Some respondents cited the availability of a clear transaction price to support their views, which might suggest more reliable measurement in these cases.

Disclosures

1.23 Most investors expressed concerns on the quality of disclosures with some respondents requesting disclosures that are currently already required by IFRS. For example, some noted that a reconciliation of carrying amounts of intangible assets should be provided by class of intangible asset in a single table as is provided for fixed assets.

1.24 Other investors requested that detailed information on the objective of a business combination and intangible assets acquired should be provided for the investors to be able to perform post-acquisition reviews. These investors, in particular, asked for extra information on the basis for the valuation of such intangible assets and any assumptions used in calculating them.

1.25 Given that these requests refer to information that is already subject to current IFRS requirements, it would suggest that either preparers are failing to comply with these requirements or that the information provided is not presented with sufficient detail and/or clarity to meet user needs.

Investor response to disclosures provided

1.26 As mentioned above, a majority of investors (74%) stated that when they did have information on amortisation of intangible assets acquired in a business combination they tended to add this back to the EPS ratios they use to assess company profitability. The main reason cited was to compensate for amortisation of "organically replaced" intangible assets. By contrast, investors noted that they didn't have the information on amortisation of internally generated intangible assets to consider similar adjustments for them.

CONCLUSIONS

1.27 This research has identified a significant level of concern amongst, at least some, investors on the accounting for intangible assets, especially those acquired in a business combination and the quality of accompanying disclosures.

1.28 As preliminary research it is not possible to draw definitive conclusions or to make clear recommendations on changes to IFRS. However, some tentative conclusions can be drawn.

1.29 The views of those investors that distinguish between "wasting" and "organically replaced" intangible assets contrast with the requirements of IFRS 3 and IAS 38 that require all intangible assets acquired in a business combination to be treated in the same way. The distinguishing characteristics the investors identify would "filter out" some intangible assets that are internally generated as the recognition criteria will include consideration of probable future economic benefits and reliable measurement. By effectively removing these hurdles for intangible assets acquired in a business combination IAS 38 does not permit a similar response.

1.30 This leads some investors to add back all amortisation even where they would prefer to only add back amortisation on "organically replaced" intangible assets which some consider to double count the cost as maintenance costs (i.e. marketing and promotional costs) also impact on reported profits.

1.31 Their views might also be interpreted as indicating a different opinion as to what constitutes an identifiable intangible asset when compared to IAS 38. These investors appear to equate identifiability with separability, whilst IAS 38 considers an intangible asset to be identifiable if it is separable or if it arises from legal or contractual rights.

1.32 It would appear reasonable to conclude that these areas are worthy of further detailed analysis and re-consideration.

1.33 There is also concern amongst respondents on the quality of company specific disclosures on intangible assets especially with regards to the rationale for capitalisation of internally generated intangible assets. Additional details on intangible assets acquired in a business combination are also thought necessary to meet user needs. However, as many of these disclosures are currently required it is not clear whether these concerns arise from a failure to fully comply with IFRS or to provide the information in such a way that is clear and easily accessible to readers.

1.34 Preparers should consider whether the form and content of the disclosures given is adequate to meet investor needs.

2. Intangible Assets Acquired in a Business Combination

Should intangible assets acquired in a business combination be included in the statement of financial position?

Always	Never	Other alternative treatment	Unsure/ No view	Total
12	2	12	1	27
45%	7%	45%	3%	100%

How should intangible assets acquired in a business combination be treated in the income statement in order to provide useful information to users of financial statements?

Amortise over UEL and assess for impairment	Do not amortise but assess for impairment	Other alternative treatment	Unsure/ No view	Total
4	7	9	7	27
15%	26%	33%	26%	100%

2.1 We asked investors whether, given the option, they would include separately identifiable intangible assets arising from business combination transactions in the statement of financial position. Investors were split between: (i) those who would always take this approach (45%); and (ii) those who opted for other ways of accounting for such intangible assets (52%).

2.2 Investors in the first category believed that including intangible assets arising from business combination transactions ensured transparency for investors about the assets acquired and the price paid. They went on to note the importance of being able to back test the management's assertions about the objectives behind the transaction through sufficient disclosures.

2.3 Investors who proposed alternative treatments of intangible assets acquired as a result of business combination transactions proposed the following:

a. A majority of these investors (37% of the overall population) proposed separation of intangible assets into "wasting" intangible assets, which they proposed should be recognised separately, and "organically replaced" intangible assets, which they proposed should be subsumed within goodwill;
b. One of these investors proposed that all intangible assets acquired as a result of business combination transactions should be subsumed within goodwill. This investor went on to propose the inclusion of disclosure notes in subsequent years' financial statements on goodwill with sufficient information to be able to perform post-acquisition reviews on management's objectives of the business combination; and

c. One investor proposed that such intangibles should be disclosed during the initial announcement of the transaction. However, this investor saw no purpose in subsequent slicing of what they saw as sunk costs and preferred to write it off.

2.4 A small minority (7%) stated that no intangible assets acquired in a business combination transaction should be recognised as separate assets in the statement of financial position. These investors believed that disclosure of such intangible assets was sufficient. When they were subsequently asked how they would account for the related proportion of the purchase price, these investors were willing to include these intangibles if they were subsumed in goodwill.

“Wasting” vs “Organically replaced” intangible assets

Some investors put forward the view that intangible assets acquired in a business combination transaction can be differentiated into two different types: (1) “wasting” and (2) “organically replaced”.

Investors termed separable intangible assets with finite useful lives and identifiable future revenue streams (e.g. wireless spectrum) as “wasting” intangible assets. They differentiated these “wasting” intangible assets from those that arise from and are renewed through the company conducting its day-to-day business (e.g. customer lists and brands) which they termed as “organically replaced” intangible assets.

Investors who make this differentiation take the view that “wasting” intangible assets have identifiable useful economic lives and revenue streams that are separate from any other asset. As such, they consider these intangible assets to be assets in their own right that should be identified separately from goodwill.

By contrast, they consider “organically replaced” intangible assets as needing to be replenished on an ongoing basis by the acquiring company through marketing and promotion. They therefore viewed the “organically replaced” intangible assets as a part of the acquired goodwill and do not agree that these should be separated out.

2.5 When asked which treatment of intangible assets arising from business combination transactions in the income statement would best reflect investor’s needs, the “organically replaced” and “wasting” intangible assets differentiation was also evident in the responses.

2.6 The largest group (33%) of investors stated that they would apply a different approach to the treatment of such intangible assets in the income statement. These investors put forward their preferred accounting treatment for “wasting” intangible assets (amortised over their useful economic lives) and “organically replaced” intangible assets (annual impairment assessment). They took the view that:

a. It is difficult to ascertain a reliable estimate of the useful life for some intangible assets such as brands and customer lists and hence impairment testing is more relevant.
b. Intangible assets such as brands and customer lists require additional annual expenditure on marketing and promotions for the acquiring company to maintain the asset and to charge amortisation would be double counting.
c. Intangible assets such as brands and customer lists should be treated in the same way as goodwill and, hence, assessed for impairment on an annual basis.

2.7 Just over a quarter (26%) of investors would not amortise any intangible assets acquired in a business combination but instead assess them for impairment annually. Their reasons for adopting this approach included:

a. Such items are similar in nature to goodwill and it was not obvious what cash-relevant running costs or reinvestment costs would be represented by the amortisation; or
b. Most investors focus on the transaction as a whole and do not look at the detailed list of purchase price allocations (PPA) which are "just a fiction that neither the company nor its advisers really look at".

2.8 By contrast, a minority (15%) of investors preferred to amortise intangible assets arising from a business combination transaction over their useful economic life and assess them for impairment on an on-going basis. One of these investors believed that the PPA process leads to clarity – a finite life and separately identified costs – which justified this approach for such assets. However, others in this group qualified their answer by stating that they would only take this approach if there was a clear view of the useful life of the intangible assets. For example, one such investor stated that "brands would never be assumed to have finite lives. Brands would be considered to have infinite lives and treated in the same manner as goodwill…If the asset has a finite useful life a charge must be made for wasting of the asset in use…Amortisation is preferable to testing for impairment as the latter introduces increased manager discretion into the valuation of assets and is an opaque procedure (which also varies internationally). Impairment arising from M&A can effectively reward overpaying in an acquisition, as impairment is 1) tax-deductible and 2) usually treated by analysts as 'one-off'."

2.9 The above results on accounting for intangible assets on the primary statements were replicated when investors were asked how they treated intangible assets and their amortisation for the purposes of company valuation or performance ratios they used.

2.10 A majority of investors (74%) stated that when considering the EPS ratios they (always or sometimes) added back amortisation on intangible assets acquired in a business combination for the following reasons:

a. Amortisation on "organically replaced" intangible assets (e.g. brands and customer lists) double counts expenditure on advertising and promotion by the company to maintain these assets. This reason does not apply to amortisation on "wasting" intangible assets (e.g. copyright material and wireless spectrum) which are similar to actual capital expenditure to buy a fixed asset. When there was insufficient information to separate the two types of intangible assets, investors noted that they added back all intangible asset amortisation even if they would prefer to be more discriminating;
b. To aid comparison of acquisitive companies and non-acquisitive companies;
c. To remove the effect of amortisation on intangible assets where they cannot identify/trackback to an acquisition/specific asset due to the lack of disclosure;
d. Amortisation is misleading as it has no cash effect; and
e. Intangible assets acquired as a result of business combinations should be subsumed within goodwill, the separation is arbitrary and the amortisation period is also arbitrary.

2.11 The questionnaire provided an opportunity after each question for investors to explain the reasons for the answers they provided. It was notable how many of the comments conveyed a sceptical view of accounting for intangible assets arising from business combination transactions in general. One investor's comment encapsulated the distrust noted by a large number of the other participants in the research. He stated that, "the treatment of intangible assets in M&A accounting can effectively reward overpaying. Lack of disclosure is the problem: the difference between tangible assets acquired and the price paid is effectively lumped together and coined 'intangibles', with little clarity of how these assets will generate revenues". Such comments were often followed by requests for further information on the nature of the intangible assets acquired and the difference they are likely to make to the company's profitability.

2.12 Investors use the business combination disclosures to assess management's stewardship of the company and its resources. A number stated that it was important for them to understand management's rationale for undertaking particular business combination transactions in context of the assets acquired and the benefits arising from the use of those assets in the combined business. Performing a test of subsequent performance against management's objectives for particular business combinations was one of the ways they assessed management's stewardship of the business.

2.13 A majority of investors (67%), asked for different or additional disclosures to those currently provided by companies; these included requests for less generic and more company specific disclosures. Some of these investors noted that the current requirement to separate identifiable intangible assets from goodwill and their subsequent amortisation sometimes made it harder to understand and assess subsequent performance against management's objective in purchasing the target. Although no actual proposals for disclosure requirements were put

forward, these investors noted that for business combination transactions they were mainly interested in understanding:

a. Why the company bought the target (access to intellectual property, access to markets or synergies); and
b. Whether the company was succeeding in its original acquisition objectives.

2.14 These investors favoured qualitative and quantitative disclosure that would enable such evaluation during the year of acquisition as well as in future years. It is notable that although IFRS 3 currently requires qualitative disclosure of the primary reasons for the business combination, it does not require that a review against those objectives be provided in the year of acquisition or subsequent years.

2.15 Investors who focused on particularly acquisitive companies stated that a table showing intangible assets split by acquisition, together with a reconciliation of amortisation and impairments during the year would be particularly helpful. Investors asked for three to ten years' comparatives for such reconciliations. Although there may be merit in standard setters addressing the former request, the latter may be better dealt with by use of technological changes in the way companies report their financial statements.

3. Internally Generated Intangible Assets

Should internally generated intangible assets be included in the statement of financial position?

Research and development costs	Development costs only	Never capitalise internally generated intangible assets	Other alternative treatment	Unsure/ No view	Total
4	13	5	2	3	27
15%	48%	19%	7%	11%	100%

How should internally generated intangible assets be treated in the income statement in order to provide useful information to users of financial statements?

Amortise over UEL and assess for impairment?	Do not amortise but assess for impairment	Other alternative treatment	Unsure/ No view	Total
14	5	1	7	27
52%	19%	3%	26%	100%

3.1 We asked investors whether they would capitalise research and development costs or only development costs for internally generated intangible assets such as internally developed software.

3.2 A majority (63%) would capitalise development costs as internally generated intangible assets, but only a small minority (15%) of all investors were prepared to also capitalise the research costs for such assets.

3.3 Those who were amenable to including the research costs did so as they believed that there was “a blurred line” between the research and development phases. These investors believed that this blurred line was exacerbated by the lack of disclosure on the rationale behind the decision to expense or capitalise research and development expenditure. These investors believed that if their proposed capitalisation of research costs does not result in value generation then they can be written off at a later date.

3.4 However, about half of all investors would capitalise only the development costs. These investors were clear that all efforts should be made to identify the differences between the research and development phases and only the latter should be capitalised. These investors favoured management clearly disclosing the basis for such differentiation in the financial statements to the extent that it was material to the future earning potential of the company.

3.5 Just under a fifth (19%) of investors would never capitalise research or development costs. These investors stated that the value and commercial benefit of such internally generated research and development costs was too difficult to verify for outsiders and that current disclosures by management did not provide sufficient information for such verification.

3.6 A small minority (7%) stated that development costs should be included when companies were developing a product capable of being sold to third parties. In the absence of this, they favoured expensing all ongoing research and development costs.

3.7 Investors’ concerns were mainly directed at the fact that the capitalised costs were subject to management judgement, the level of disclosures companies provided meant that investors were unable to independently verify them and their treatment was far from consistent across companies, reducing comparability.

3.8 A number of investors, regardless of their views on the costs to be capitalised, cited the valuation of internally generated assets as being extremely opaque. In particular, investors expressed concern that no arm’s length transactions verified the valuations attributed to the internally generated intangible asset and the disclosures provided by companies in this area were insufficient to explain this.

3.9 Investor views on the treatment of internally generated intangible assets on the income statement were consistent with the views they expressed on the capitalisation of such assets.

3.10 Just over half (52%) of the investors believed that internally generated intangible assets, such as software development costs, should be amortised over their useful economic lives and assessed for impairment on a regular basis. These investors considered the development expense as a true economic expense that requires replacement at a later date. They stated that:

a. They would not expect significant impairments for such assets;
b. Impairments for such assets were indicators of management's stewardship of the company's resources; and
c. Financial statements did not provide the level of granularity to assess the reasonableness of impairments on such assets.

3.11 Just under a fifth (18%) of investors would prefer that such intangible assets were only assessed for impairment on an annual basis. These investors either stated that: costs and useful economic lives for such assets are not verifiable for them from purely looking at the information provided in the financial statements, rendering any amortisation subject to management's judgement; or that there is a high probability of failure of internally generated intangible assets in certain industries (e.g. biotechnology and pharmaceutical companies) and so amortisation is meaningless.

3.12 This view of internally generated intangible assets as a genuine asset was further confirmed by investors when asked about how they treat amortisation on such assets when considering the EPS. Just over half (52%) of the investors never add back amortisation on internally generated intangible assets to the EPS. The main reason being that shareholder capital had been used to generate an asset with a finite useful life the wasting of which must be charged to the relevant revenue. However some noted that such amortisation was too hard to separate out from the disclosures provided by companies.

3.13 A minority (26%), who always or sometimes add back the amortisation on internally generated intangible assets, stated that they focused on the actual spending on such intangible assets. Such investors often cited that they were attempting to value the company and so focused on measurements of performance excluding amortisation charges.

4. Separately Acquired Intangible Assets

Should separately acquired intangible assets be included in the statement of financial position?

Always	Never	Other alternative treatment	Unsure/ No view	Total
24	0	0	3	27
89%	0%	0%	11%	100%

How should separately acquired intangible assets be treated in the income statement in order to provide useful information to users of financial statements?

Amortise over UEL and assess for impairment?	Do not amortise but assess for impairment	Other alternative treatment	Unsure/ No view	Total
15	2	2	8	27
56%	7%	7%	30%	100%

4.1 This was the least controversial type of intangible assets amongst investors. The current IFRS requirements, in particular on capitalisation of such assets, appear to be in line with a majority of investors' expectations.

4.2 The vast majority (89%) of investors stated that such intangible assets should be separately identified on the statement of financial position. They mainly cited the availability of a price paid in the market and a clear useful economic life for the asset as being the main drivers for their view.

4.3 However, some diversity of views appears when considering the income statement treatment of such intangible assets. Over half (56%) of investors agreed that separately acquired intangible assets such as copyright material and wireless spectrum should be amortised over their useful economic lives on the basis that there is a verifiable cost attached to the intangible assets and their useful economic life is determinable.

4.4 A small minority (7%) believed that such intangible assets should only be assessed for impairment on an annual basis. These investors cited a lack of easily accessible information on amortisation at the asset level in the financial statements and stated that impairment tests may result in more useful information being disclosed in the financial statements.

4.5 A further minority (7%) believed that such assets should only be amortised where there is a price and reliably determinable useful economic life, otherwise they preferred such assets to be tested for impairment on an annual basis. These investors particularly raised doubts about the reliability of useful finite lives ascribed to some copyright materials with very long lives.

4.6 These views were also reflected when investors were asked whether they add back amortisation on such intangible assets to earnings per share. A majority (55%) of investors stated that they did not add back amortisation on separately acquired intangible assets as they are wasting in nature with an ascertainable finite life and a verifiable price. By contrast, a minority (19%) of investors stated that they always or sometimes added back amortisation on separately acquired intangible assets. These investors stated that they did this where the finite useful life was not always obvious or determinable from the information in the financial statements.

5. Adequacy of Presentation and Disclosure

5.1 Investors were asked for their views on disclosures of intangible assets as well as any other concerns they had with the financial statements provided. The following is a list of the issues raised by investors:

a. Capitalisation of intangible assets;
b. Disclosures about mergers and acquisitions; and
c. Adequacy of disclosures.

Capitalisation of intangible assets

5.2 Some investors were concerned about the proliferation of intangible assets and the implications for reported capital. As one investor noted, "the fact that more and more companies are resorting to some sort of pre-PPA *[Purchase Price Allocation]* measure of profitability shows that PPA has been a waste of time".

5.3 Another stated that accounting for intangibles and goodwill is currently like a black box from the investor perspective. For example, in the aerospace and defence sector, expenditure on research and development is huge but the companies within that sector interpret IFRS differently. That investor went on to note that there is too much leeway in interpretation of IFRS in this area, as some companies capitalise all expenditure whilst others capitalise none, leading to significant differences on key metrics.

5.4 Other investors put forward concerns with the proliferation of internally generated intangible assets stating that they believed that internally generated intangible assets should only be recognised once the company has identified a selling price i.e. the asset is marketable; up to that point it should be expensed through the income statement.

5.5 By contrast, some investors put forward arguments for recognition of even more intangible assets. These investors noted that knowledge-based companies are often capital light, because their business processes are based on knowledge assets, but have huge market values indicating the non-recognition of some intangible assets. These investors noted that the accounting requirements currently do not reflect the true value of such companies. This view was

articulated by one investor as follows: “Investors are increasingly being forced to focus on cash flows, despite the disadvantages of this approach, as the balance sheet and P&L fail to reflect the realities of trading. As the nature of value creation changes so must financial statements. A separate intangible asset statement (independent of taxation) should be considered.”

Disclosures about mergers and acquisitions

5.6 A significant number of investors raised concerns about the disclosures provided by companies on the objectives of business combination transactions, the components purchased and any subsequent impairment. These investors viewed provision of such disclosures as management providing information so as to aid an assessment of whether they are fulfilling their business stewardship responsibilities on behalf of the shareholders and were disappointed by the level of information provided.

5.7 A number of proposals were put forward by investors about additional information they would like to see in an enhanced disclosure on mergers and acquisitions. These are:

a. a list of intangible assets acquired in a business combination transaction;
b. subsequent amortisation and impairment;
c. Weighted Average Cost of Capital (WACC) for the combined group upon acquisition;
d. Qualitative and quantitative disclosure on objective of acquisition – scale, capability, synergy; and
e. A post-acquisition review – reporting back at later date on the achievement or lack thereof of the business combination objectives.

5.8 Other investors proposed a disclosure containing up to 10 year history of acquisitions of intangible assets showing the price paid and subsequent amortisations/impairments by vintages of the acquisition. They believed that such a disclosure would help differentiate the companies that are serial acquirers from those that grow organically.

Adequacy of disclosures

5.9 Most investors were dissatisfied with the current disclosures for intangible assets in general. A number of them noted that, current disclosures in financial statements contain insufficient detail to permit meaningful analysis of either purchased or internally generated intangible assets. These investors often proposed a disclosure setting out a reconciliation of intangible assets that was similar in nature to those for tangible assets. They noted the following items should be included in such a reconciliation:

a. gross spend or capitalised amounts, by the categories of intangible assets (some proposed wasting and organically replaced should be included as categories);
b. method of valuation e.g. hierarchy of valuation and cash flow assumptions used;
c. subsequent amortisation and impairment for each category of intangible assets;
d. a rationale for how the figure included on the statement of financial position originated; and
e. commercial reasons behind the company's acquisitions or development of intangible assets, in particular for asset light companies.

5.10 A number of these investors believed that such disclosure would facilitate analysts adjustments to these numbers e.g. permit them to treat customer lists and brands as goodwill.

5.11 This request appears to be the same as the disclosure requirements in IAS 38 and IFRS 13 *Fair Value Measurement*. It is notable that a number of investors requested a reconciliation for intangible assets that was similar in nature to tangible assets. Preparers following the requirements in IAS 38 should already be providing such a disclosure in their financial statements. The investors' consistent requests indicate either a lack of compliance by preparers or that the disclosures are not providing enough company specific information or presenting that information in a way so as to be useful to these users of financial statements.

5.12 A number of investors also asked for additional disclosures on the impairment tests. These investors noted that accounting for goodwill and intangibles currently creates the risk of artificial value creation and they needed to understand the rationale behind the impairment testing by management to independently verify this was not the case. Suggestions for additional disclosures included:

a. where discounted cash flows (DCF) are used in the impairment test, information on projections and discount rates used should be provided;
b. details of independent valuations used;
c. other assumptions applied to goodwill valuation; and
d. other assumption used in the impairment test.

5.13 Once again, investors appear to be requesting disclosures that are already required by IFRS, in this case IAS 36 *Impairment of Assets,* indicating either a lack of compliance by preparers or that the disclosures are not providing enough company specific information or presenting that information in such a way as to be useful to the users of financial statements.

APPENDIX 1

Research methods

1. The aim of the research was to gauge investor views on the accounting treatment of different classes of intangible assets in the statement of financial position and their amortisation in the income statement. A questionnaire was used for this purpose. It asked investors' views on the accounting treatment of different classes of intangible assets in the financial statements as well as the implications of the amortisation of intangible assets for key performance indicators (KPIs) they used specifically referring to Earnings Per Share (EPS). The questionnaire went on to ask for views on inconsistency of treatment between various types of intangible assets, the relevant disclosures provided in financial statements and whether these were sufficient for investors' purposes.

2. Investors were asked whether they use measures such as EPS. Investors were then asked to identify the types of intangible assets for which they may add back amortisation to the EPS measure. They were given a choice of: intangible assets arising from business combinations; internally generated intangible assets; and separately acquired intangible assets. They were asked to explain the rationale for their choices.

3. A total of 33 investors were approached by research staff and 27 agreed to take part. A range of investors (including fund managers, buy-side equity analysts, and one sell-side analyst) participated in the research. Most of these investors are based in the UK with a minority based in Germany.

4. The questionnaire was sent to the investors to consider. They were given the option of: (1) completing the questionnaire and returning it to the research staff; or (2) taking part in one-to-one interviews with the research staff to discuss their views. All bar three took up the second option.

5. Research staff analysed the result to understand the range and diversity of investor views in this area. The nature of this research topic is such that it is only attractive to a subset of investors. As a result, it is difficult to draw definitive conclusions that can be generalised to the wider population of investors whose focus may not be on the research topic.

Timing of the research

6. The research period spanned from April 2013 to January 2014.

6. Contact Details

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