



Financial Reporting Council

February 2019

Business Reporting of Intangibles: Realistic proposals

A Discussion Paper prepared by staff of
the UK Financial Reporting Council

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

The FRC does not accept any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.

© The Financial Reporting Council Limited 2019
The Financial Reporting Council Limited is a company limited by guarantee.
Registered in England number 2486368. Registered Office:
8th Floor, 125 London Wall, London EC2Y 5AS



February 2019

Business Reporting of Intangibles: Realistic proposals

A Discussion Paper prepared by staff of
the UK Financial Reporting Council

Contents

Invitation to comment	3
1 Introduction	6
2 Which intangibles should be reported as assets?	9
3 Disclosure of expenditure on intangibles	15
4 Narrative reporting	17
5 Implementation	20
References	21

Invitation to Comment

Background

1. The FRC issued a Research consultation in 2018 to gather stakeholder views on potential research projects; stakeholders supported further research on intangibles. The topic has also been identified internationally by other accounting standard-setters as a key area of research.

Objective

2. The objective of this paper, 'Business Reporting of Intangibles: Realistic proposals' is to add to the international debate, gather views and influence the IASB and its future work agenda.
3. The FRC is requesting comments by 30 April 2019. Comments are invited on all issues relating to possible improvements to the business reporting of intangibles. Comments are sought on the questions below.
4. Comments are most helpful if they indicate the specific paragraphs to which they relate, contain a clear rationale and, where applicable, suggest an alternative approach.
5. Please specify in your response if you are a preparer of financial statements, a user of financial statements, an advisor or auditor, academic, standard setter or other party interested in corporate reporting.

Request for comments

Section 1 Introduction

6. This section sets out the objectives of this paper, which are to explore reasons why many intangibles are not fully reflected in the financial statements and to develop practical proposals for improving business reporting of intangibles.



Question 1

Do you agree that it is important to improve the business reporting of intangibles?

Section 2 Which intangibles should be reported as assets?

7. This section reviews the implication of the IASB's *Conceptual Framework*'s requirements that an intangible can only be recognised as an asset in financial statements if it meets the definition of an asset; and recognition provides relevant information about the asset and a faithful representation of it.
8. The main proposals made in this section are:
 - (i) An intangible should be recognised at cost only where:
 - the costs to be incurred on development of an intangible asset can be estimated at the time when a project to develop an intangible is undertaken. The amount capitalised should not exceed these estimated costs in view of the difficulty of establishing the future economic benefits; and

- the economic benefits to be derived from the intangible can be specified when the costs are first incurred, and hence a relevant method of amortisation or monitoring for impairment can be established.
- (ii) For many intangibles the measurement uncertainty of fair value is so great as to call into question whether it could provide a representationally faithful depiction.
- (iii) The requirements of existing accounting standards should be reviewed in light of these conclusions.



Question 2

Do you agree that an intangible should be recognised at cost under the two conditions set out above in (i)?

Question 3

Do you agree with the assumptions the paper makes regarding measurement uncertainty of intangibles?

Question 4

Do you agree that existing accounting standards should be revisited with the aim of improving the accounting for intangibles?

Section 3 Disclosure of expenditure on intangibles

9. The main proposals made in this section are:
- (i) There is a case for specific disclosure requirements of the amount and nature of investments in unrecognised intangibles that are treated as an expense in the period, particularly those that are incurred with a view to generating benefit in subsequent accounting periods ('future-oriented intangibles'). These should be clearly differentiated from expenses that unambiguously relate to the period.
 - (ii) The cumulative amount of future-oriented expenditure that is expected to benefit future periods, and movements in it, should be disclosed.



Question 5

Do you agree with the above proposals relating to expenditure on intangibles?

Section 4 Narrative reporting

10. This section discusses how narrative reporting might usefully complement the information provided in financial statements, both as regards recognised and unrecognised intangibles. The main proposals are:
- (i) Management should select the intangibles that are discussed in narrative reporting, by reference to those that are most relevant to the entity's business model.
 - (ii) Narrative reporting should include metrics relating to intangibles. It is questionable whether an estimate of the value of intangibles will be useful, but other metrics should provide information that is helpful to investors in making their own assessment of intangibles and their impact on financial performance.

- (iii) Metrics should be reported for several reporting periods, so that the trend is clear.
- (iv) Management should comment on the factors that have caused a change in metrics and compare the reported metrics with their realistic targets.
- (v) The definition and calculation of metrics might be standardised within specific industries.

**Question 6**

Do you agree with the proposals aimed at improving the quality of information on recognised and unrecognised intangibles in narrative reporting?

Section 5 Implementation

11. This section suggests ways in which participants in the business reporting process could improve the reporting of intangibles.

**Question 7**

What are your views about how the various participants involved in business reporting could or should contribute to the implementation of the proposals made in the paper?

Further questions**Question 8**

Do you use additional information other than the financial statements when assessing and valuing intangibles? If so, can you please specify what additional information you use.

Question 9

Do you have any suggestions, other than those put forward in this paper, as to how improving the business reporting of intangibles might be achieved?

1 Introduction

Objectives

- 1.1 *“Over the last 15 years or so there have been a number of calls for accounting reforms, with claims that the traditional historical cost approach has outlived its usefulness. One of the claims made in this debate is that the economy has changed in fundamental ways, that business is now fundamentally ‘knowledge based’ rather than industrial, and that ‘intangibles’ are the new drivers of economic activity. Based on those claims, commentators contend that one of the key problems faced by financial reporting is that financial statements fail to recognise many of the most important knowledge-based intangibles, such as intellectual capital, and that this has adversely affected investment in intangibles. This has led to calls for accounting-standard setters to re-evaluate how intangibles are accounted for and to make reforms.”*
- 1.2 The above paragraph introduced a paper¹ first published in 2008. The only revision that is required today is to replace ‘over the last 15 years or so’ with ‘over the last quarter century or so’. Criticisms that financial reporting fails to provide relevant information about intangibles continues. For many years Baruch Lev has been one of the leaders of this criticism: he has recently published a book (co-authored with Feng Gu) memorably titled ‘The End of Accounting’.

Those who take the view that the shift to the new economy has caused financial statements to lose much of their relevance for investment decisions often cite the divergence between the accounting value of equity (net assets) and companies’ market capitalisation. They suggest that this is due to the failure to recognise the value of intangibles in financial statements. There are, however, reasons to be sceptical about this argument.

Although financial statements may be expected to provide information that is useful to an assessment of the value of a company’s equity, they have never pretended to provide that value directly. This has most recently been confirmed in the IASB’S Conceptual Framework (IASB 2018, paragraph 1.7). Many items in financial statements are reported at historical cost rather than fair value, which would be indefensible if the objective were to report the value of the company.

Essentially, financial statements are a record of past transactions. They reflect the extent to which past transactions have resulted in assets to the extent they might provide future cash inflows (and, of course, liabilities to the extent they might require future cash outflows). In contrast, the market value of equity reflects an assessment of future cash flows.

But even if all assets and liabilities were recognised and reported at fair value, differences between reported equity and market capitalisation might be expected. A long-standing puzzle in the finance literature is why shares in funds, such as investment trusts, often trade at a discount (and occasionally at a premium) to their net asset values, despite the regular reporting of the fair value of their net assets. For a discussion of this puzzle, see Shleifer (2000, Chapter 3).

Some researchers dispute the claim that financial statements have lost relevance despite the advent of the new economy—for example, Penman (2007), and Skinner (2008). A particularly thorough recent study is Barth, Li & McLure (2018) which suggests that ‘our findings reveal a more nuanced, but not declining, relation between share price and accounting information that reflects the new economy’.

¹ Skinner (2008). Footnote references omitted.

- 1.3 The objectives of this paper are:
- to explore the reasons why intangibles cannot be more fully reflected in financial statements without radical change; and
 - to develop practical proposals for improvement in business reporting that can be expected to be implemented in the near future.
- 1.4 Examples of intangibles include: patents, copyrights, trademarks, knowledge, skills, permits, licenses, computer software, customer lists, relationships, business processes, and dynamic capabilities (such as the ability to adapt to new working methods). Clearly this is not an exhaustive list. It is also obvious that the examples are diverse: a license to operate has little in common with a supplier relationship, except that neither is tangible, and that a business that has a license to operate and good supplier relationships is more valuable than one that lacks either.
- 1.5 The IASB's *Conceptual Framework* (IASB 2018), which has recently been revised, sets out definitions of assets and recognition criteria. Only items that both meet the definition and the recognition criteria can be included in financial statements without radical change. While the possibility of radical change cannot be discounted, it undoubtedly will not be achieved in the near future. The immediate priority is to identify how, within the current financial reporting framework, practical proposals can enhance the relevance and quality of information that is conveyed by financial reporting.
- 1.6 Within the current *Conceptual Framework*, financial statements can only deal with those intangibles that meet the definition of assets and satisfy the recognition criteria, as set out in the IASB's *Conceptual Framework*. However, it seems unlikely that this will be sufficient: it is also necessary to consider how financial reporting of those intangibles that do not meet either the definition of assets or the recognition criteria might be improved. This might be by narrative reporting rather than within the financial statements. That is why our title for the project is 'intangibles' rather than 'intangible assets'.
- 1.7 Our working definition of 'intangibles' is:
- Intangible factors that are important to an entity in its creation of value, whether or not they are secured by legal means and whether or not they meet the current definition of 'assets'.*

Scope of project

- 1.8 However, to restrict its proposals to maintain focus, some limitations on the scope of this paper are necessary. So, this paper focuses on 'business reporting' which excludes:
- reporting by entities in the public and not-for-profit sectors; and
 - reporting to meet the needs of stakeholders other than those defined as the primary users of financial reporting in the *Conceptual Framework* (that is, existing and potential investors, lenders and other creditors).
- 1.9 These topics are not excluded because they are unimportant, or because this paper's proposals are necessarily irrelevant to future initiatives to address them. But it acknowledges that, in considering extending the proposals to these areas, it may be necessary to modify or adapt them.
- 1.10 However, as mentioned above all forms of business reporting, including the management commentary, are addressed in this paper. It is not confined to the financial statements but discusses other forms of business reporting such as in the management commentary.

- 1.11 Financial reporting of goodwill and its impairment are also not addressed in this Discussion Paper. The IASB plans to issue a Discussion Paper or Exposure Draft on Goodwill and Impairment in the second half of 2019, and EFRAG has recently completed research on the same subject.² Revisiting goodwill and its impairment within this project would therefore duplicate the work of others.

Structure of this paper

- 1.12 The remainder of this paper is structured as follows:

- **Section 2** discusses the implications of the *Conceptual Framework* for the reporting of intangibles. It relates its conclusions to the economic features of intangibles that are identified in the literature.
- **Section 3** considers possible improvements to the reporting of expenses incurred to develop intangibles that cannot be capitalised in financial statements but are expected to benefit future periods ('future-oriented intangibles').
- **Section 4** discusses how narrative reporting, including the use of metrics, might be used to provide better information for investors on intangibles.
- **Section 5** notes that further consideration is required of the implementation of the suggestions made in the paper and the role of preparers, investors, and standard-setters in that process.

² Information on EFRAG's Research Project Goodwill – Impairment and Amortisation can be accessed here: <http://www.efrag.org/Activities/261/EFRAG-Research-Project-Goodwill—Impairment-and-Amortisation>

2 Which intangibles should be reported as assets?

- 2.1 The IASB's Conceptual Framework requires that an intangible can be recognised in financial statements only if:
- (i) it meets the definition of an asset; and
 - (ii) recognition provides relevant information about the asset and a faithful representation of it.

The definition of an asset

- 2.2 The definition of an asset requires that there is a present economic resource that is controlled by the entity. IAS 38 'Intangible Assets' requires an intangible asset to be 'identifiable'. An intangible is identifiable if it either:
- (a) is separable—that is, capable³ of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged; or
 - (b) arises from contractual or other legal rights.
- 2.3 It is explained in IAS 38 that the requirement for an intangible asset to be 'identifiable' is included to distinguish the asset from goodwill. However, it would seem equally effective in ensuring that the item meets the key parts of the definition of an asset, which requires that there is a present economic resource that is controlled by the entity. There must be boundaries to an asset: it must be clear what is and is not included. Only then can it be asked whether the entity has control of that resource.
- 2.4 It therefore appears that the identifiability test is consistent with the *Conceptual Framework* and makes sense. This conclusion, however, leaves open the possibility that the way in which the implications of the identifiability test are applied within current IFRSs is questionable
- 2.5 It is clear that some intangibles will fail to meet the definition of an asset and/or the identifiability test. For example, customer loyalty is important for many businesses but (unlike a customer **list**) cannot be sold or otherwise made available to others (except on the sale of a business as a whole). Also, as identified in IAS 38, an entity does not have sufficient control over its skilled workforce (and the training that has created those skills) to meet the definition of an asset.

Recognition

- 2.6 As noted above, the *Conceptual Framework* states that recognition is only appropriate where it provides relevant information about the asset and a faithful representation of it. It discusses several factors that should be considered in determining whether these are met. The most pertinent for this paper is the implication that there must be a relevant measurement basis, and that the level of measurement uncertainty is not so great that recognition would not provide a faithful representation. Possible measurement bases for intangible assets are cost (see paragraphs 2.7–2.14) and fair value (see paragraphs 2.16–2.24).

³ Here 'capable' should be interpreted to mean that a transfer is possible rather than such a transfer would be economically sensible. Consider, for example, a whisky producer which has (i) a still; (ii) a legally protected trademark; and (iii) an enviable reputation for the quality of its products. It might be possible **in principle** to sell either the still and the trademark: they are therefore identifiable assets, notwithstanding that such a sale is highly unlikely to be made except on a transfer of the business as a whole. But its reputation cannot be sold by itself: although some of the benefits of ownership of that reputation might possibly follow a sale of its trademark, it is impossible to imagine how a sale of its reputation without that trademark or other assets of the business could be described or enforced.

Cost

- 2.7 The difficulties of using cost as a measurement basis can be brought out by contrasting the economic features of intangible assets with those of tangible assets such as property, plant and equipment and inventory. Typically, in the case of tangible assets:
- (i) the cost of the asset is known or can be estimated within reasonable bounds when the asset is acquired; and
 - (ii) the economic benefits that will be derived from the asset, and when they will be consumed, are reasonably clear.
- 2.8 It is therefore reasonable to assume that a tangible asset will provide economic benefits that are at least as great as the cost incurred in its acquisition. Hence those costs are capitalised and charged as an expense only when the asset is consumed (as depreciation or on derecognition of the asset).
- 2.9 In contrast, for many intangibles cost is unclear, as they are not the result of a project that can clearly be separated from the entirety of the entity's business activities. A customer list, for example, will often be simply a by-product of trading activities: it cannot be determined to what extent the cost of past trading activities was incurred to generate that list: perhaps none was incurred with the purpose or intent of generating that list. Also, some valuable inventions are the product of serendipity—famous examples include the post-it-note and penicillin—and hence may have little or no identifiable cost.
- 2.10 In other cases there might be a specific project, for example to develop a new product or process and the costs of that project might be separately recorded from the outset. But, especially if the project involves the search for new knowledge, it may be difficult or impossible to confidently predict the total costs to complete the project.
- 2.11 Not only the costs, but also the economic benefits that will be derived from investment in intangibles, can be hard to quantify. It is in the nature of innovation that many projects will fail and be abandoned and provide little or no benefit to the entity.
- 2.12 Even a successful project may not provide the anticipated benefits. One reason commonly cited in the literature is 'spillovers'⁴—innovation breeds imitators: competitors may develop their own products with similar functionality. While legal protection can sometimes be obtained by patents and copyrights, this is not always effective.
- 2.13 Other economic features of intangibles—scalability, synergies and network effects—can affect their value. These are discussed in connection with fair value below (see paragraph 2.21). However, they also give rise to serious difficulties for the measurement of consumption or impairment of intangible assets which are reported at cost.
- 2.14 For the above reasons, it seems that reporting intangible assets at cost will often not provide relevant information. At the minimum it would seem to be necessary that:
- (i) the costs to be incurred on development of an intangible asset can be estimated at the time when a project to develop an intangible is undertaken. The amount capitalised should not exceed these estimated costs in view of the difficulty of establishing the future economic benefits; and
 - (ii) the economic benefits to be derived from the intangible can be specified when the costs are first incurred, and hence a relevant method of amortisation or monitoring for impairment can be established.

⁴ For example, see Lev (2001) p33ff, Haskel & Westlake (2018) pp77ff.

When an intangible is acquired by purchase, its cost will be as evident as any other asset. Presumably the acquirer's management will have a view that they are willing to justify about the timing of the economic benefits that are expected from the purchase. But it is much less likely that the criteria in paragraph 2.14 will be met for those intangibles that are developed internally. The proposals therefore imply a continuation of the existing difference in accounting between purchased and internally-generated intangibles.

This has significant consequences. It impairs comparability between companies that have acquired similar intangibles by different means.

Furthermore, a company considering acquiring preliminary research carried out by private individuals might consider either:

- (i) recruiting the researchers to join its own staff (in which case their remuneration will probably be reported as an expense, which will decrease earnings of each period); or*
- (ii) encouraging the researchers to set up a separate legal entity in which it undertakes to provide an equity stake (in which case its investment will probably be reported as an asset, an investment, with no impact on earnings unless and until it is clear that the investment is impaired).*

However, the only means of remedying this are either to require that all research expenditure is capitalised without limit, or to require that cash paid for investments is, in some circumstances, to be reported as an expense. Neither solution seems appropriate.

Fair value

- 2.15 If intangible assets are to be recognised in financial statements, fair value is the most obvious alternative to cost. IAS 38 currently permits intangible assets to be recognised at fair value, measured by reference to an active market. While acknowledging that such markets may exist for assets such as *'freely transferable taxi licences, fishing licences or production quotas'*, it states that *'it is uncommon for an active market to exist for an intangible asset'*. The following discusses whether it would be possible for fair value to be used more widely for capitalising intangible assets in financial statements.
- 2.16 IFRS 13 'Fair Value Measurement' identifies three widely-used valuation techniques: the market approach, the cost approach, and the income approach.
- 2.17 The **market approach** *'uses prices and other relevant information generated by market transactions involving identical or comparable' assets*. Many intangible assets, however, are not traded: Lev (2001, page 45) attributes this to *'contracting difficulties, negligible marginal costs and fuzzy property rights'*. Many intangible assets are 'context specific'—that is, they may have little or no value to a purchaser (Haskel and Westlake 2018, p70), and this impedes the development of markets. Furthermore, when transactions in intangibles do occur the prices are rarely made public.
- 2.18 Perhaps an even more formidable obstacle to the use of the market approach is that of the uniqueness of intangibles. As IAS 38 notes:
- "an active market cannot exist for brands, newspaper mastheads, music and film publishing rights, patents or trademarks, because each such asset is unique."* (paragraph 78)
- 2.19 Many tangible assets are unique including some, such as investment properties, that are reported at fair value. Every warehouse is unique, as there is no other building in precisely the same location. However, there are (usually) other warehouses within the same area that offer similar economic benefits. It is therefore possible to value a

warehouse by reference to transactions in other essentially similar assets. But the uniqueness of intangibles is of a different order: every patent and every novel are intrinsically different from every other one. Even if the price at which a patent was recently sold were known, it would not be possible to base a valuation of a different patent on that information. Lev & Gu observe: *‘Pfizer’s patents are nothing like Merck’s, and Coca-Cola’s brands (Nestea) bear no resemblance to Pepsi’s (Doritos)’* (page 88).

- 2.20 The **cost approach** *‘reflects the amount that would be required currently to replace the service capacity of an asset’*. Deriving fair value under this approach therefore requires estimating the costs of developing an equivalent intangible asset. But, as noted above, it is often difficult to estimate in advance the costs of developing an intangible. Unless these difficulties can be overcome, the cost approach would be impracticable.
- 2.21 The **income approach** essentially converts future cash flows (or income and expenses) to a discounted present value. The calculation may be similar to that of value in use; however, to arrive at fair value, the future income must be estimated from the perspective of market participants rather than that of the entity. Therefore, applying the income approach requires an insight into how market participants would assess the benefits that will be obtained from an intangible asset. The literature attests to the following features that affect the benefits of intangibles and therefore make application of the income approach difficult, if not impossible.
- **Scalability.** The idea of scalability (sometimes also referred to as ‘non-rivalry’) is that an intangible asset can be used without limit. A supply of oranges can be used to make marmalade, but only a certain amount. In contrast, a recipe can be used to make marmalade without any fixed limit. Of course, the size of the market may restrict the amount that can *profitably* be made according to the recipe, but it is impossible to estimate in advance this limit. Or if an entity has developed all that is necessary for a successful coffee bar—the brand, operating processes, design, and supply network etc.—it may be able to replicate that in many other locations.
 - **Network effects.** As Haskel and Westlake note (2018, page 66): *‘Scalability becomes supercharged with “network effects”’*. The value of an intangible asset often depends upon the extent to which it becomes adopted by others. Lev (2001, pages 24–27) gives the example of the Sabre reservation system, originally developed by American Airlines, which came to account for more than half the value of American Airlines as it became the preferred reservation system in the travel industry.
 - **Synergies.** Most intangible assets do not create income on their own but only in conjunction with other assets. A patent for an ingenious invention, for example, is of no value except to an entity that also has the capacity to get the product manufactured, marketed and distributed—which requires a collection, sometimes extensive, of other assets both tangible and intangible. It is therefore difficult or impossible to say how much of the expected benefits should be ascribed to the patent and how much to other assets. Of course, an inventor may capture the value of her patent by licensing the rights to another entity, but as the patent is inherently unique, the value that will be derived from a future licensing arrangement is unknowable.
- 2.22 IFRS 13 addresses how fair value may be derived where assets are difficult to value. But its objective is to prescribe the methodologies for arriving at fair value, not the circumstances in which fair value should be used. The discussion above suggests that, for many intangibles, the measurement uncertainty of fair value is so great as to call into question whether it could provide a representationally faithful depiction.

2.23 IAS 38 asserts that:

“If an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset. When, for the estimates used to measure an intangible asset’s fair value, there is a range of possible outcomes with different probabilities, that uncertainty enters into the measurement of the asset’s fair value.” (paragraph 35)

- 2.24 Perhaps this should be reconsidered. Previous FRC research⁵ suggests that some investors question the relevance of separating intangible assets (other than those that are separable, have finite lives and lead to identifiable revenue streams) from goodwill. The IASB also received the message in its *Post-Implementation Review of IFRS 3 ‘Business Combinations’* that some investors believe that the identification of some intangible assets separately from goodwill is inappropriate.

Conclusions

- 2.25 The above discussion suggests that many intangibles cannot be recognised in financial statements given the *Conceptual Framework’s* definition of assets and recognition criteria. Some might urge a reconsideration of the *Conceptual Framework* which would permit more intangibles to be recognised within financial statements. Changes that would allow more intangibles to be recognised as assets within the financial statements would need to be carefully assessed to ensure that improvement in relevance is not obtained at a disproportionate cost of reducing the objectivity and reliability of financial statements.

- 2.26 The IASB has recently completed its revision of the *Conceptual Framework*;⁶ the revisions proposed in the Exposure Draft to the definition of assets and the recognition criteria were generally supported by respondents and have been carried forward to the revised *Conceptual Framework*. Thus, it would appear unlikely that a convincing case for further change can be made, or that suggestions for such change would be acceptable in the near future. For this reason, this paper focuses on how, within the current financial reporting framework, practical proposals can enhance the relevance and quality of information that is conveyed in business reporting.

- 2.27 Perhaps surprisingly, the suggestion that the current definitions of assets and recognition criteria should be retained are consistent with the views expressed by others that have been critical of current reporting of intangibles. For example, the *Report of the Brookings Task Force on Intangibles* stated:

*“After some internal debate and extensive interviews with individuals preparing financial statements, user, auditors, standard setters, and regulators, the task force has concluded that the debate about capitalization versus expensing of R&D focuses on the wrong problem. What investors want, and need is information about the value of internally developed intangibles and the other factors that drive the value creation process in firms.”*⁷

- 2.28 Baruch Lev has for many years been a prominent critic of the reporting of intangibles. Yet in his recent paper (Lev 2017) he too proposes only a limited expansion of the capitalisation of intangibles, consistent with the current definition of assets.

⁵ Financial Reporting Council: *FRC ARP Staff Research Report: Investor Views on Intangible Assets and their Amortisation* (2014). Available at <https://www.frc.org.uk/accountants/accounting-and-reporting-policy/research/investor-views-on-intangible-assets-and-their-amor>

⁶ At the time of writing, the revised *Conceptual Framework* is expected to be published in March 2018. References in this paper to the *Conceptual Framework* are to the Exposure Draft *Conceptual Framework for Financial Reporting* of May 2015, as modified, where noted, by subsequent tentative decisions of the IASB.

⁷ *Unseen Wealth*, page 67, footnote reference omitted.

2.29 Rather than increasing the extent to which intangibles are recognised as assets in financial statements, the most promising routes to explore are:

- reviewing the existing requirements of accounting standards and comparing the extent to which their detailed requirements conform to the *Conceptual Framework*;
- considering how financial statements might provide better information about expenditure on intangibles that are not recognised as assets (see Section 3 below); and
- addressing the business reporting of intangibles outside of the financial statements, for example in narrative reporting (see Section 4 below).

3 Disclosure of expenditure on intangibles

- 3.1 Many intangibles will not be recognised in financial statements as they fail to meet the definition of an asset or the recognition criteria. Examples include staff training, and brand-building through advertising. As no asset is recognised as a result of expenditure on such activities, it will be reported as an expense, even though it is undertaken with a view to enhancing the financial returns in subsequent accounting periods. As a result:
- reported net income is reduced in the period in which the expenditure is made; and
 - the higher financial returns achieved in subsequent accounting periods appear unusually large, as the costs incurred to achieve those returns have already been written off.
- 3.2 There is often a significant time lag between incurring expenditure on intangibles and the receipt of return from it. This may provide an opportunity for a form of earnings management as the current period's net income can be increased by cutting expenditure on, for example, advertising; the damage caused to the entity's ability to sell may not be apparent until subsequent years.
- 3.3 Although IAS 38 requires fairly extensive disclosures about recognised intangible assets and changes in their carrying amounts, it has few disclosure requirements about expenditure on intangibles that are not capitalised. The *'aggregate amount of research and development expenditure recognised as an expense during the period'* is required to be disclosed, but there are no specific requirements for disclosure of other expenditure on intangibles.⁸
- 3.4 There is therefore a case for specific disclosure requirements of the amount and nature of investments in unrecognised intangibles that are treated as an expense in the period, particularly those that are incurred with a view to benefit in subsequent accounting periods. For convenience, such intangibles are referred to in this paper as 'future-oriented intangibles'.
- 3.5 This might be developed by requiring such expenditure to be clearly differentiated from expenses that unambiguously relate to the period.⁹ If this were adopted, the statement of profit or loss would provide information on:
- (i) net income before investment in future-oriented intangibles; and
 - (ii) expenditure on future-oriented intangibles, analysed by nature.
- 3.6 Such a presentation would assist users to distinguish the financial performance of the period, without the distortion caused by expenses that are charged to profit or loss simply as a matter of accounting policy, and which relate to the period only in that they are incurred in the period and do not satisfy the requirements to be recognised as assets.
- 3.7 In implementing this idea, it will be necessary to consider whether intangible expenditure that is expected to benefit future periods can be distinguished from that which is recurrent. Some advertising, for example, predominantly supports sales made in the current period, while other advertising enhances the value of a brand, by assisting penetration of a new market. This may be an issue on which accounting standards can give only limited guidance.

⁸ It is possible that some entities may disclose expenditure on intangibles separately either voluntarily or consider they are required to do so by the general requirement of IAS 1 'Presentation of Financial Statements' to present separately items of a dissimilar nature or function (paragraph 29), but there are no other specific disclosure requirements.

⁹ A similar suggestion is made by Barker and Penman (2017).

- 3.8 Some might conclude that, unless accounting standards can set out robust definitions, a requirement to separately report investment in future-oriented intangibles provides too much latitude to management, so the information would lack comparability: they therefore would not support such a requirement.
- 3.9 Others, while acknowledging this concern, might consider that the requirement would provide relevant information, and that supplementary disclosures could enhance its relevance and mitigate concerns about comparability. Such disclosures could include:
- (a) the accounting policy for distinguishing between current period expenditure and future-oriented expenditure;
 - (b) the nature of the intangibles on which expenditure has been incurred;
 - (c) the cumulative amount of current and past expenditure on each class of future-oriented intangibles that has been written off and is expected to provide future benefits; and
 - (d) the periods in which benefits from current and past expenditure on each class of future-oriented intangibles are expected to be derived.
- 3.10 The following example illustrates how the cumulative amount of future-oriented expenditure might be presented in, for example, a note to the financial statements rather than the primary financial statements themselves. The amounts shown as 'expenditure in the year' will be the amount treated as an expense in statement of profit or loss.

<i>Production staff training for the future</i>	20X1	20X2
	£'000	£'000
Cumulative amount at the beginning of the year	510	627
Expenditure in the year	337	418
Deemed to have benefited current year	(170)	(209)
Reduction to reflect the abandonment of project X	(50)	—
Cumulative amount at the end of the year	<u>627</u>	<u>836</u>
Training for production staff is deemed to benefit operations over the average product cycle of three years.		

4 Narrative reporting

- 4.1 While the preceding sections have identified some improvements that might be considered for the reporting of intangibles in financial statements, in themselves they will not fully meet the needs of investors for better information to help them assess the contribution of intangibles to the performance and prospects of a business.
- 4.2 Narrative reporting not only enables the provision of information on unrecognised intangibles: it can also amplify what is reported within the financial statements.
- 4.3 The term ‘narrative reporting’ is used here to include reports that with titles such as ‘Management Commentary’ or ‘Strategic Report’ generally form part of the annual report, and also other information (such as Preliminary Earnings Announcements) that an entity provides primarily for the information of investors.
- 4.4 Narrative reporting should be integrated into any pertinent information in financial statements. It should therefore not only be consistent, but also the relationship between information in the financial statements and narrative disclosures should be clear.

Selection of intangibles

- 4.5 It would not be practicable to suggest that narrative reporting should discuss all intangibles; most businesses have innumerable intangibles, and even if a comprehensive report could be produced at reasonable cost, it would be difficult to discern the most pertinent information. Rather, a narrative report should focus on those intangibles that are most important for the value-added activities of the business, that is, those that play a key role in the business model. For example, customer loyalty is probably very important for a business that offers a subscription service such as a phone company, but it may not be important for a business that produces a basic product such as metal ore and sells its output on commodity markets. A company that manufactures products to its customer’s specifications may engage in little research and development itself, but that would be critical for a company in an industry such as pharmaceuticals where innovation is a significant driver of financial performance.
- 4.6 It would therefore seem unwise to prescribe which intangibles should be discussed in narrative reporting, but it might be informative if management discussed the reasons for their selection of those intangibles that should be addressed.
- 4.7 The most relevant information will be different for entities in different industries. Moreover, even within the same industry the most relevant intangibles may vary. A shoemaker that focuses on the luxury market may not be significantly affected by its manufacturing efficiency as margins are high, but strict control over the cost of goods would be relevant for a shoemaker that trades in a competitive, price-sensitive environment.
- 4.8 A focus on those intangibles that are most relevant to the entity’s business model (including both those that are reported in the financial statements and those that are not) is consistent with the FRC’s *Guidance on the Strategic Report* (July 2018), which includes the following.

“4.5 The strategic report should provide additional explanations of amounts recognised in the financial statements and explain the conditions and events that shaped the information contained in the financial statements. The strategic report should also include information relating to sources of value that have not been recognised in the financial statements and how those sources of value are managed, sustained and developed, for example a highly trained or experienced workforce, natural

capital, intellectual property or intangible assets, as these are relevant to an understanding of the entity's development, performance, position or future prospects.

4.6 The success of a company is dependent on its ability to generate and preserve value over the longer term. Companies do not exist in isolation; they need to build and maintain relationships with a range of stakeholders in order to generate and preserve value.

...

7A.16 A critical part of understanding an entity's business model is understanding its sources of value, being the key resources and relationships that support the generation and preservation of value. In identifying its key sources of value, an entity should consider both its tangible and intangible assets and also identify those resources and relationships that have not been reflected in the financial statements because they do not meet the accounting definitions of assets or the criteria for recognition as assets. This information may provide insight into how the board manages, sustains and develops these unrecognised assets."

Metrics

- 4.9 The usefulness and credibility of narrative information may be enhanced by the inclusion of metrics, i.e. numerical measures that are relevant to an assessment of the entity's intangibles. Because they are more objective and verifiable, metrics complement the inevitably subjective narrative discussion of management's achievements against its objectives.
- 4.10 It is doubtful if the value of an intangible will often be a particularly useful metric. The formidable obstacles to the valuation of intangibles are summarised in paragraphs 2.15–2.24 above. Investors require information that helps them to make their own assessment of intangibles and their impact on financial performance; reporting subjective valuations may displace information that would enable greater insight.
- 4.11 The following are examples of metrics that might be disclosed:
- A company that identifies customer loyalty as a critical to the success of its business model might disclose measures of customer satisfaction, such as the percentage of customers that make repeat purchases.
 - If the ability to innovate is a key competitive advantage, the proportion of sales from new products might be a relevant metric.
 - Where the skill of employees is a key driver of value, employee turnover might be disclosed, together with information on their training.
- 4.12 It is probable that the metrics that are most relevant to inform investors are the same as those that are used by management in running the business. In this case, they will be readily available at little or no incremental cost.
- 4.13 The disclosed metrics should not only relate to intangibles that are relevant to the success of the business but also provide a meaningful insight into their potential. It might be questioned, for example, whether disclosure of the number of patents granted is particularly meaningful unless information about their nature is also given. Patents for an innovative product might be more indicative of future prospects than patents for improved packaging.
- 4.14 Metrics will only be credible if their definition is clear. If, for example, the proportion of sales for new products is disclosed, unambiguous criteria for what counts as a 'new product' are necessary.

- 4.15 A metric for a single period may provide little information, but if the same metric is disclosed for several periods, calculated on a comparable and consistent basis, the trend will give more insight. However, while trends may provide a sense of whether the position is getting better or worse, metrics need to be supported by a management's discussion, as their significance is difficult for an outsider to judge. For example, is employee turnover of 20% satisfactory or worryingly high or low?
- 4.16 That discussion should, where possible, give management's views of:
- the factors that have caused change in the metrics; and
 - how the reported metrics compare with management's realistic targets.
- 4.17 The following example illustrates how these proposals might be implemented:

CUSTOMER SATISFACTION			
	20X1	20X2	20X3
Repeat customer ratio	55.0	60.0	65.2
<i>(Percentage of customers who purchase again within 12 months)</i>			
<i>We believe that the increase in the repeat customer ratio reflects improvements in both our products and customer service. It continues to fall short of our target of 75%.</i>			
	20X1	20X2	20X3
Return ratio	8.0	6.0	6.1
<i>(Value of products returned as a percentage of items delivered)</i>			
<i>As we consider it a necessary investment in our relationship with customers, we willingly accept customer returns. However, we recognise that returned sales indicate a disappointing customer experience and also increase our costs. The reduction in returns in 20X2 followed changes to our product specifications to provide more helpful information about our products. The slight increase in 20X3 was due to returns of new product X: excluding product X, the return ratio was 5.8%.</i>			
<i>We aim to achieve a return ratio of 5%.</i>			

- 4.18 Disaggregation of some metrics can enhance their relevance. Employee turnover of product designers, for example, may have a different significance from that of delivery drivers.
- 4.19 As the *Conceptual Framework* notes, 'information about a reporting entity is more useful if it can be compared with similar information about other entities'. However, as noted above, the relevant intangibles and their metrics will vary significantly between companies, so it would not be practicable to prescribe all possible metrics.
- 4.20 However, there is at least anecdotal evidence that users are frustrated by differences in the calculation of metrics used by businesses within the same industry. It would seem feasible to establish certain metrics for use within a given industry using agreed definitions and calculations. This would promote comparability and also add to their credibility.

5 Implementation

- 5.1 The previous sections of this paper have suggested several proposals for improving the business reporting of intangibles. Further consideration is required as to how practice might be changed to secure their adoption. There appears to be opportunities for all involved in financial reporting to make positive change.
- 5.2 **Preparers** of annual reports can review their current practice in the light of what is proposed, benchmark their achievements against competitors and consider improvements which can be made on a voluntary basis. As many of the most useful metrics are entity-specific, they may wish to promote, perhaps through industry associations, the adoption of common definitions of the most widely-used metrics.
- 5.3 **Investors** can share their views on the reporting of intangibles with companies in which they have a holding, including drawing attention to information that they would find useful that is not currently disclosed.
- 5.4 Rigid requirements, robustly enforced, may not be an appropriate means of securing change. Guidance that sets out what may be considered best practice may be a more suitable means of encouraging the evolution of best practice. **Accounting standard-setters** may have a role to play in the development of such guidance: they are well placed to promote dialogue among their stakeholders and to identify best practice. And guidance, even if not mandatory, could benefit from an enhanced status if endorsed by a standard-setter.

References

- Barker, Richard and Penman, Stephen (2017) *Moving the Conceptual Framework Forward: Accounting for Uncertainty*
<https://www8.gsb.columbia.edu/ceasa/sites/ceasa/files/files/Moving%20the%20Conceptual%20Framework%20Forward%20Accounting%20for%20Uncertainty.pdf>
- Barth, Mary E, Li, Ken and McClure, Charles (2018) *Evolution in Value Relevance of Accounting Information – Working paper* (Stanford University)
- Blair, Margaret M & Wallman, Steven MH (Task Force Co-Chairs) (2001) *Unseen Wealth: Report of the Brookings Task Force on Intangibles* (Brookings Institute Press)
- Financial Reporting Council (2014) *FRC ARP Staff Research Report: Investor Views on Intangible Assets and their Amortisation*
<https://www.frc.org.uk/accountants/accounting-and-reporting-policy/research/investor-views-on-intangible-assets-and-their-amor>
- Financial Reporting Council (2018) *Guidance on the Strategic Report*
<https://www.frc.org.uk/getattachment/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf>
- Haskel, Jonathan and Westlake, Stian (2018) *Capitalism Without Capital: The Rise of the Intangible Economy* (Princeton University Press)
- IASB (International Accounting Standards Board) (2018) *Conceptual Framework for Financial Reporting*
- IFRS Foundation (2016) Red Bound Volume IFRS 3 *Business Combinations*; IFRS 13 *Fair Value Measurement*; IAS 1 *Presentation of Financial Statements*; IAS 38 *Intangible Assets*
- Lev, Baruch (2001) *Intangibles: Management, Measurement and Reporting* (Brookings Institute Press)
- Lev, Baruch (2017) *The Deteriorating Usefulness of Financial Report Information and How to Reverse It*. Paper presented at the ICAEW Information for Better Markets Conference, December 2017
- Lev, Baruch and Gu, Fen (2016) *The End of Accounting and the Path Forward for Investors and Managers* (Wiley)
- Penman, Steven H (2007) *Financial Reporting Quality: Is fair value a plus or a minus?* Accounting and Business Research Special Issue (International Accounting Policy Forum), pp 33–44.
- Shleifer, Andrei (2000) *Inefficient Markets: An Introduction to Behavioural Finance* (Oxford University Press)
- Skinner, Douglas J (2008) “Accounting for Intangibles—a Critical Review of Policy Recommendations” *Accounting and Business Research* 38:3, 191–204.

For ease of handling, we prefer comments to be sent by e-mail to:

intangibles@frc.org.uk

Comments may also be sent in hard copy to:

Andrew Lennard
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

Comments should be despatched so as to be received no later than 30 April 2019.

The FRC's policy is to publish on its website all responses to formal consultations issued by the FRC unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. The FRC does not edit personal information (such as telephone numbers or postal or e-mail addresses) from submissions; therefore, only information that you wish to be published should be submitted.

The FRC aims to publish responses within 10 working days of receipt.

The FRC will publish a summary of the consultation responses.



Further copies, £19.00 (post-free) can be obtained from:

FRC Publications

Lexis House
30 Farringdon Street
London
EC4A 4HH

Tel: **0845 370 1234**

Email: **customer.services@lexisnexis.co.uk**

Or order online at: **www.frcpublications.com**

ISBN 978-0-7545-5666-4

