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Intangibles: First Thoughts

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Views expressed are tentative and not necessarily those of the FRC.

Objectives of this session

- Provide information on the FRC's project on intangibles
- Obtain feedback on preliminary ideas
- Enable participants to express interest in contributing to the project

Project objectives

Objectives

- To review current business reporting of intangibles; and
- To develop practical proposals for their improvement that can be expected to be implemented in the near future.

Intangibles

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'.

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Scope: exclusions

Important omissions

- Public and not-for-profit sectors
- Reporting to stakeholders other than investors

…and (for clarity)

- Exploration for mineral resources
- Financial instruments
- Goodwill

Which intangibles should be reported as assets?(1)

- Those that meet the definition of assets and where measurement uncertainty does not prevent a faithful representation

Definition (IAS 38 principles)

- Identifiable:
  - Separable
  - Arises from contractual or other legal rights

Principles seem OK—
details to be reviewed later in the project

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Which intangibles should be reported as assets?(2)

Cost

- May not be identifiable for internally generated intangibles
- Eventual cost may not be predictable at the outset
- Future economic benefits uncertain
- Consumption difficult to track

For many intangibles,

cost will not provide representationally faithful information

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Which intangibles should be reported as assets?(3)

Fair value

- Intangibles are entity-specific and price information is rarely available
- Intangibles are unique (incomparable)
- Value uncertain due to:
  - Scalability
  - Network effects
  - Synergies

For many intangibles,
fair value will not provide representationally faithful information

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Expenditure on ‘future-oriented intangibles’

Disclose

- Expenditure on investment in future-oriented intangibles
- Net income before investment in future-oriented intangibles
- Nature of these intangibles
- Cumulative amount expected to provide future benefits

Cumulative expenditure: illustration

Production staff training for the future	20X1 £'000	20X2 £'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	627	836

Training for production staff is deemed to benefit operations over the average product cycle of three years.

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Narrative reporting

- Focus on intangibles that are relevant to the business model (value creation)
- Include metrics (rather than value)
  - Clearly defined
  - Disaggregated
  - Trends
  - Targets

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Metrics: Illustration

CUSTOMER SATISFACTION			
	20X1	20X2	20X3
Repeat customer ratio (Percentage of customers who purchase again within 12 months)	55.0	60.0	65.2
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%.			
	20X1	20X2	20X3
Return ratio (Value of products returned as a percentage of items delivered)	8.0	6.0	6.1
As online retail does not enable our customers to inspect the goods before ordering, we willingly accept customer returns. However, we recognise that returned sales indicate a disappointing customer experience, as well as increasing our costs. The reduction in returns in 20X2 followed changes to our website 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%. We aim to achieve a return ratio of 5%.			

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Questions for discussion

1. What advice would you give to the FRC on the objectives and scope of the intangibles project?
2. Should the existing definition of assets and the recognition criteria be changed to permit more intangibles to be reported as assets in the financial statements? If so, what changes should be considered?
3. Should the separate reporting of expenditure on future-oriented intangibles be required? If so, what are the main challenges in introducing such a requirement?
4. Do you agree that narrative reporting including metrics can assist users of financial statements in assessing an entity's intangibles? Are there factors that significantly enhance the relevance of metrics that are not addressed in the paper?
5. How could accounting standard-setters assist in the implementation of the ideas suggested in the paper for narrative reporting? Which other parties should be involved, and what would their role be?

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