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EFRAG Research Project

Better Information on Intangibles

Issues Paper

Objective

- 1 The objectives of the session are to discuss:
 - (a) the issues that could be addressed in the project; and
 - (b) the possible approaches for the research project.

Project background

- 2 Corporate reporting has been a subject of significant debate in recent years. The views diverge on how to enhance its quality and usefulness to investors, analysts and financial institutions. While attention has focused primarily on integrated reporting and environmental, social and governance (ESG) reporting, identifying and better reporting the meaningful information on intangible value drivers is also important to the broader debate on improving the quality of corporate reporting.
- 3 Investors are increasingly interested in long-term strategies and value creation of corporates and, consequently, in intangible factors that companies have at their disposal, whether these are recognised or not.
- 4 At the same time, concerns have been voiced that financial statements are losing their relevance as they do not reflect many of these intangible elements.
- 5 Enhanced information about intangibles is undoubtedly a key to providing views on long-term sustainability of business models.
- 6 Moreover, the European Commission paper *Unlocking Investment in Intangible Assets*, published in 2013, called for improvements in “reporting on investments in all relevant intangibles and as a driver of value creation” and noted the broader benefits for users, preparers and society at large as this may “facilitate getting access to finance (capitalised intangibles might be used as collateral), improve corporate governance and market transparency”.

Preliminary considerations based on the input collected so far

- 7 Based on the findings from literature review commissioned by EFRAG (*the literature review*), the limited outreach conducted by the EFRAG Secretariat with a range of stakeholders and feedback to the UK Financial Reporting Council’s (UK FRC) recent Intangibles consultation *Business Reporting of Intangibles: Realistic Proposals*, some preliminary findings can however be outlined:
 - (a) Information on unaccounted intangibles tends to be directly and positively correlated with company performance and cash flow;

- (b) There is a correlation between the level and quality of information and the accuracy analysts' earnings forecasts;
 - (c) Voluntary disclosures about intellectual capital can facilitate analysts forecasting process, especially if the value of intellectual capital is not easily verifiable;
 - (d) Although financial report 'deficiencies' may partially compensate for by other information sources available to them, better quality reporting is called for to enable investors to understand value creation;
 - (e) Need enhanced information about intangibles as this is key to providing a view on the long-term sustainability of business models want, and need is information about the value of internally developed intangibles and the other factors that drive the value creation process in firms;
 - (f) Mixed evidence was found as to the incremental value-relevance of capitalising more assets (versus disclosing more information) and whether that information would be given credence by users. This is also consistent with the feedback received by the UK FRC from its Discussion Paper.
- 8 The literature review also outlined that, since 1980s, preparers have internally developed and used various models to assess how they create and how they enhance company value; those models include BCG matrix, balanced scorecards etc. However:
- (a) Limited quantitative data is publicly available. There is no common practice to report the results of such practices in the financial statements; and
 - (b) Various frameworks or tools have been developed to capture the value of intangibles. However, their use is often voluntary, and none of them is used widely.
- 9 Several reporting frameworks have been created to present the information regarding intangibles outside of financial statements (e.g. WICI framework).
- 10 However, unless using integrated reporting, companies do not provide information that would bridge the financial statements with those non-financial reports using audited financial information or disclosures.
- 11 During the interviews, conducted by EFRAG Secretariat in February and March 2019, we also learned that institutional users often used informal information channels to fill the information gap and to bridge financial and non-financial reports; such information channels, however, are not available for less sophisticated and smaller investors and other stakeholders including employees and community/society.
- 12 The above is in line with the messages from the IASB's Investors' Update, that:
- (a) Many investors already use sophisticated approaches to incorporate information on intangibles into their analysis and valuation of companies; and
 - (b) Investors can best analyse intangibles using capitalisation techniques and non-financial information on the risks and return potential of intangibles.

Possible scope for the project

- 13 At the July 2019 EFRAG TEG meeting, members suggested that EFRAG's research should focus on considering whether information about how an entity creates, maintains, expands and/or preserves value could be provided in a way useful for investing decisions.
- 14 Some members cautioned about looking holistically at the value creation process as this would result in a scope that is too broad for EFRAG to manage.

- 15 This paper explores possible approaches to implement the recommendations of EFRAG TEG.
- 16 For the sake of this discussion, this paper uses the term 'intangibles' to include a potentially wide range of assets and other factors that drive the creation of value in companies, whether or not they are currently recognised or reported in annual reports and financial statements.
- 17 Having considered the results of the literature review, interviews, and the suggestions received from EFRAG TEG, we consider that the research could focus on a narrow scope and consider the financial aspects of value creation and the needs for the primary users of financial statements and management commentary, opposed to the creation of value to other stakeholders such as employees, environment and community/society.
- 18 Information about value creation can encompass a broad set of financial and non-financial information such as information about the business model, competitive advantages, risk, business strategy, resources and relationship capital.
- 19 A possible approach would be to look at those intangible value drivers in a comprehensive way. This is because the processes to generate, maintain and enhance the intangibles is often difficult to distinguish from the entity's operations. The number of issues to be considered would be almost infinite. Therefore, it would be necessary to focus on some issues that are the most important regarding entity value creation.
- 20 The research project could then focus on financial reports including narrative information, and consider reporting measures of value, including drivers of value creation and risk (e.g. customer attrition rates), disaggregation of expenses, or other performance measures. The research would aim to identify 'solutions' and good practices that would improve reporting on intangibles and better enable users to do their own assessments of intangibles.
- 21 This would be consistent with EFFAS assessment¹ that, regarding intangibles, analysts and investors are essentially interested in indicators directly related to a company's operating and/or financial market performance (including clarifying the link to value creation in a narrative way).
- 22 The EFRAG Secretariat also observes that, in the context of its consultation about its future agenda, the EFRAG Corporate Lab is considering a project on 'Reporting of non-financial risks and opportunities, and linkage to the business model'. This project, if selected, would undoubtedly also address intangible value drivers from a non-financial information standpoint. EFRAG's research focusing on financial value drivers, could therefore provide valuable insight into value creation while supplementing but not overlapping with the European Lab activities.
- 23 An expected additional benefit of the envisaged research about unrecognised intangibles could be to act as a bridge between the information provided on financial and non-financial value drivers of a business focusing on ways to enhance corporate reporting.
- 24 The possible solutions identified in our research would provide a good starting point for all users (not only the primary users) to analyse value creation drivers and the information provided in non-financial reports. Finally, the bridge would comprise audited information.

¹ EFFAS *Principles for Effective Communication of Intellectual Capital*.

Questions for EFRAG TEG

- 25 Does EFRAG TEG agree with the scope proposed in paragraphs 15 to 20 or rather with the alternative scope?

Should EFRAG focus its research on selected industries or selected types of intangibles?

- 26 Another aspect to consider is that drivers of value are likely to be specific to sectors or activities and having a comprehensive approach across all sectors may not be the most appropriate and effective way to approach the matter.
- 27 The Literature Review commissioned by EFRAG suggests users' preference for industry-specific reporting addressing companies' own circumstances and risks with respect to their value creation process rather than identical guidelines across the different industries and that 'any guidance about improved disclosure on intellectual assets (i.e. intangibles) should remain principles-based given the wide range of intellectual assets held by firms in different industries, as it allows companies flexibility in applying the guidance.
- 28 This is also consistent with the OECD 2006 Report on *Intellectual Assets and Value Creation: Implication for Corporate Reporting* which concluded that 'the development of industry-specific indicators by the private sector would seem to offer the best way forward since they can accommodate the very different role the various intellectual assets play from sector to sector'.
- 29 EFRAG could therefore consider, in a first stage to select a limited number of sectors and/or of types of intangibles and analyse:
- (a) How entities report on how they create, maintain and/or improve value in these sectors / for these intangibles;
 - (b) How users consume information on how entities create, maintain and/or improve value and the extent to which current reporting addresses their needs in these sectors / for these intangibles; and
 - (c) Provide suggestions on how information about how an entity creates, maintains and/or improve value in these sectors / for these intangibles can be provided in financial reports in a manner that would be useful for decisions on providing resources to the entity.
- 30 In a second stage, EFRAG could consider whether and how some of the principles identified for that limited scope exercise could be generalised to other sectors or other types of intangibles.
- 31 Intangible investment is not evenly distributed across industries. Industries with the highest intangible intensity (those that invest most in intangibles relative to their size) in Programming and Information and Pharmaceuticals, and the lowest in Basic Metals, Mining and Transport².
- 32 A possible approach could consist selecting a limited number of intangible-intensive sectors, in manufacturing and in-service industries to maximise learnings and address a broader set of circumstances. EFRAG could for instance consider two or more industries such as:
- (a) *The Pharmaceuticals*, a heavily regulated sector where practices have emerged to 'model' the value of some intangibles. This sector is the most

² OECD Report (May 2019) Productivity Growth and Finance: The Role of Intangible Assets – A Sector Level Analysis

intangible intensive, according to the OECD measure, particularly in knowledge-based intangibles (according to the OECD classification).

- (b) *Programming and Information* sector is the most intangible intensive service industry. It is less regulated and intensive in both knowledge-based intangibles and organisation-based intangibles and includes sectors such as software publishing (including gaming), IT consultancy services, IT Management Services.

- 33 An alternative approach could instead consist in focusing on the nature of intangibles (rather than the industries). EFRAG could select several intangibles and look at how their different features are relevant in terms of financial reporting. The literature review commissioned by EFRAG has identified that very few research projects have addressed information needs of users for certain types of intangibles such as internally generated brands, patents, customer relationships.
- 34 Lastly, EFRAG could consider combining a by-industry approach (looking comprehensively at relevant intangibles across selected industries and their connections) and a by nature of intangibles approaches (looking in depth at information needs for selected intangible). Such a combined approach could foster the insight gathered and identification of both issues and solutions.

Questions for EFRAG TEG

- 35 Which of the approaches, described in the above paragraphs, does EFRAG TEG suggest EFRAG Secretariat to follow?
- 36 Does EFRAG TEG consider that the research should follow a by-industry or a by-nature of intangibles approach?
- 37 If a by-sector approach is followed, does EFRAG TEG agree with the sectors suggested by the EFRAG Secretariat? If not, which sectors or industries would you advise the Secretariat to consider in priority?
- 38 If a by-nature approach is followed, which types of intangibles would you suggest EFRAG Secretariat should focus on?

Understanding how information can be provided in a useful way to users

- 39 Improving information on intangibles requires actions on many fronts. Not only must companies learn to analyse and report their intangible assets more systematically, but also financial analysts and investors must be able to interpret this additional information and to efficiently integrate it with their existing valuation procedures.
- 40 The literature review commissioned by EFRAG provided evidence that only a limited number of studies have addressed how investors, analysts, and other users consume the information about unaccounted intangibles, and what are their information needs. Some research papers have quantitatively looked at the way and frequency of information on intangibles mentioned in analysts' reports. However, only few have reached out directly to them to interview users on their needs.
- 41 The recent consultation on the UK FRC Discussion Paper *Business Reporting of Intangibles: Realistic Proposals* has provided further evidence that there is a need to understand how information about intangibles is consumed by users, before considering any reporting solutions or improvements.
- 42 Therefore, EFRAG research could focus on identifying what information primary users need about intangibles, where the information is currently sourced from, and how it is practically used in making their decisions.
- 43 It is also noteworthy that, in August 2019, the Institute of Chartered Accountants of Scotland (ICAS) issued a positioning paper and a call for research to explore the

needs of users. The EFRAG Secretariat maintains regular contacts with ICAS on the matter. needs of users.

- 44 The EFRAG Secretariat considers that fostering dialogue between preparers and users is critical to the success of the project.
- 45 For that reason, we suggest setting up a forum associating users and preparers, facilitating dialogue and helping practical solutions to emerge. Such panel would include an equal number of users and preparers.
- 46 This panel could, for instance, consider (but would not be limited to) the following issues:
- (a) How to provide information on a company's intangible supporting the assessment of its performance and investors' and other users in their assessment of companies' prospects;
 - (b) How to report the extent to which management have maintained/enhanced those drivers of value to sustain value creation into the future;
 - (c) Identify current best practices on the above matters and identify the principles that underpin them;
 - (d) Determine whether guidance on the above areas should be mandatory or voluntary or a combination of both;
 - (e) How user, in the selected sectors, currently value intangibles and what type of information they need to do so;
 - (f) Can intangibles be 'monetised' and how to measure and report on those drivers of current value in meaningful terms;
 - (g) Consider how current practices could be improved (develop solutions and test their feasibility);
 - (h) How to provide information about the maintenance and enhancement of intangibles in a way that is useful to users.

Questions for EFRAG TEG

- 47 Does EFRAG TEG agree that setting up a Panel to facilitate exchanges between users and preparers is an appropriate approach?
- 48 Does EFRAG have comments on the list of issues to be considered by such panel as provided in paragraph 46 above?

Interaction with the forthcoming Management Commentary Practice Statement ('MCPS') consultation

- 49 EFRAG's research on reporting on intangibles provides an opportunity to gather input and insight that will be useful in responding to the forthcoming MCPS consultation (expected over H2 2020) and influencing future decisions.
- 50 Although no formal decisions have been made yet by the IASB as to the exact content of the revised MCPS, members of Management Commentary Consultative Group, as well as ASAF have repeatedly advised the IASB to place greater emphasis on intangible resources.
- 51 The IASB has clarified that the MCPS will remain a principle-based document that will not provide detailed reporting requirements or suggest KPIs. Instead it is expected that the MCPS will set as a principle, that when management identifies 'resources and relationships that the entity depends on for its long-term success', it would need to provide qualitative and quantitative information necessary for primary

- users' understanding of the nature and importance of those resources and relationships (and their continued availability) to the future operation of the business.
- 52 To support that principle, the MCPS is expected to provide high-level guidance and identify 'commonly held' resources and relationships but is not expected to provide an exhaustive list of such items nor a list of related disclosures, as these would be specific to entities and circumstances.
- (a) *Commonly held relationships* may include customer relationships, sourcing relationships, staffing relationships, and wider relationships, including with government, regulators, and society at large;
 - (b) *Commonly held resources* may include operating sites and infrastructure; operating sites and infrastructure; expertise, know-how and other intellectual capital; brand and reputation; access to natural resources, etc.
- 53 The MCPS is expected to identify some types of information that Users may need in specific circumstances for instance:
- (a) *Depending* on the relationship, primary users may need information to help them evaluate the durability of the relationship, the lifecycle of the relationship and the entity's dependency on the relationship or its vulnerability to disruption to the relationship.
 - (b) *Primary* users may need information about the extent of customers' dependency on the entity to meet their ongoing service needs. Management commentary also provides information about any concentration of risk resulting from a relationship or group of relationships.
- 54 EFRAG Research could help assessing whether the high-level guidance suggested in the forthcoming MCPS would be likely to help meet the information needs of users (for instance whether the identified 'commonly held resources and intangibles are appropriate, whether the guidance strikes a right balance between historic and forward-looking information, between quantitative and qualitative information).

Questions for EFRAG TEG

- 55 Does EFRAG TEG have comments or suggestions on the interactions between EFRAG research and the forthcoming MCPS consultation?