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Better Information on Intangible Assets Reason for the Project Cover Note

Objective

- 1 The objective of this session is to discuss how to proceed with EFRAG Research Project *Better Information on Intangibles* ('the Project').
- 2 This agenda paper provides a background summary and explains the basis of the reasons for the project.

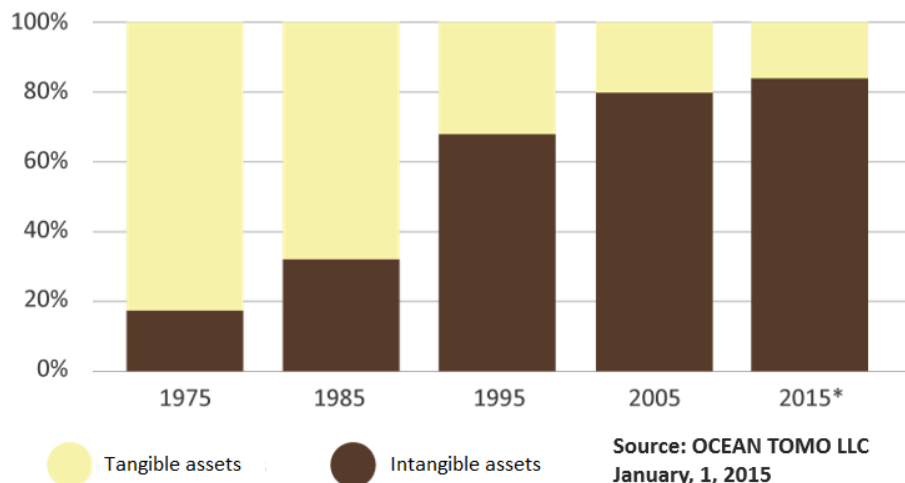
Background

- 3 In August 2018, following the input received from constituents in response to the EFRAG Research Agenda Consultation, the EFRAG Board decided to add a research project on better information on intangible assets to its research agenda. The following project aims were identified:
 - (a) to address some aspects in relation to internally generated intangible assets. The aspects that may be considered include a categorisation and description of the different types of assets (marketing, technological, social, reputational or human capital) and how their different features are relevant in terms of financial reporting;
 - (b) to investigate how to consider uncertainties that exist both in relation to the entity's ability to access future benefits and their amount and timing; this includes, for example, considering the ability of competitors to duplicate the entity's resource, barriers for usage and spill-overs; and
 - (c) to develop metrics to express earning potential and value through measurement or disclosures.
- 4 It was specified that the Project would not focus on how to make the book value of an entity and the entity's market capitalisation equal. However, the possible solutions may include amending IAS 38 *Intangible Assets*.
- 5 In April 2019, EFRAG TEG and User Panel members received an update on the project regarding the interviews conducted by the EFRAG Secretariat. EFRAG TEG and User Panel members had mixed views on the objective of the Project. They indicated that providing information on how companies create and sustain long-term value, and providing more information on future cash flows, would be useful. They also agreed that the Project should not focus on filling the gap between the company's equity book value and its market capitalisation.
- 6 Nevertheless, EFRAG Secretariat highlights the feedback received from users where they generally support improving the quality of reporting on intangibles. This feedback is summarised in the section of this paper "*Why this project?*".
- 7 At this stage, the project will not focus on debating recognition and measurement versus disclosure. This may be considered in a later phase.

- 8 To obtain an overview of the most important academic studies in the area, EFRAG has commissioned an academic literature review. The review will cover studies on:
- (a) intangibles in a macro perspective;
 - (b) value relevance of intangibles;
 - (c) the impact of specific internally generated intangibles on firm profitability and market value and the impact of disclosures on these on investors and information users;
 - (d) the impact on intangibles (including intellectual capital) on firm profitability and market value and the impact of disclosures on these on investors and information users; and
 - (e) reporting models and frameworks for intangibles.
- 9 The review thus focuses on intangibles in a broader sense than items that would meet the definition of an intangible asset.

Why this project?

- 10 The feedback from 2018 EFRAG Research Agenda Consultation identified that improving financial reporting on intangible assets would be well received. The input gathered from constituents was as follows:
- (a) Accounting for intangible assets has gained prominence in the past few decades due to changes in the business environment, which includes:
 - (i) changes in technologies;
 - (ii) changes in customer behaviour;
 - (iii) rise of international trade of intangibles; and
 - (iv) increasing share of investments in intangible assets in total investments (see the graph below);



The above figure shows the results of a survey conducted to assess the overall market value of publicly traded organizations compared to their balance sheet book value. (SP 500 Market Value)

- (b) It is debateable whether IFRS-based financial statements provide a full picture (i.e. whether information is relevant and consistent) of the value drivers of businesses; and
- (c) It would be worthwhile to further examine the conceptual basis for the discrepancies between the accounting treatment for acquired and internally generated intangibles.

- 11 It is noteworthy that these overall considerations were further confirmed and supported by the Financial Reporting Council (UK FRC) in responses to its publication *Business Reporting of Intangibles: Realistic Proposals*, where a majority of the respondents agreed that the existing reporting framework has limitations in capturing and presenting clearly the nature and value of intangibles. The investors were unanimous in their support for improving the quality of reporting on intangibles. However, the feedback received by UK FRC comes mainly from UK organisations and, therefore, there is merit in reaching out to other European constituents. More information on this and the follow projects is available in Agenda Paper 03-03 for the July 2019 EFRAG TEG meeting.
- 12 The Corporate Reporting Users' Forum (CRUF), in its response to the UK FRC publication, highlighted the need for improved disclosures regarding identifiable cash flows, separability and justification for assessment of intangibles' useful economic life (definite, indefinite, etc.).
- 13 Additionally, CRUF supported revisiting the current requirements of IAS 38. CRUF welcomed improving the disclosures on recognised intangible assets, to enable users to classify them as either operating intangibles or non-operating intangibles. Moreover, this disclosure improvement could be useful to support entities' investment decisions.
- 14 In its comment letter in response to EFRAG Discussion Paper *Should Goodwill Still Not Be Amortised? Accounting and Disclosure for Goodwill*, CRUF also suggested that:
 - (a) users need to measure the performance of management with reference to the stewardship over money they spent and on year performance; and
 - (b) to assess management stewardship, users need to measure ROIC ratio (Return on Invested Capital) including acquisitions and ROCE ratio (Return on Capital Employed) with intangibles removed, to put all companies on a similar basis as if they all have grown organically.
- 15 In addition, these comments corroborate the comments received by EFRAG Secretariat during the interviews (for details, see the Agenda Paper 06-02 for Joint EFRAG TEG and User Panel meeting in April 2019). It was considered that something could be improved in the manner the information is provided about intangibles in the financial statements.
- 16 The Association of Chartered Certified Accountants (ACCA) published a report *R&D Expenditure, Disclosure, Content and Quantity, and Stakeholder Views where it* indicated that some of the findings could not be explained due to lack of available information. This includes the reasons for not following the industry capitalisation practises.
- 17 Moreover, all above comments are aligned with the views of European Federation of Financial Analysts Societies (EFFAS) which, in 2008, established a Commission on Intellectual Capital and issued the *Principles for Effective Communication of Intellectual Capital*.
- 18 Finally, the *Report of the Brookings Task Force on Intangibles*, mentioned by the FRC in its 2019 publication, indicated that after some internal debate and extensive interviews with individuals preparing financial statements, user, auditors, standard setters, and regulators 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.

Next steps

- 19 The EFRAG Secretariat plans the following four stages of the Project:
- (a) *Literature Review*: performing a qualitative analysis based on relevant academic papers with the selected academic team, mentioned in the Background of the project. We expect this phase to be finalised by the end of Q3/2019 and the report to be publicly presented in September and October 2019.
 - (b) *Problem Description*: gathering information in order to formally define and describe the problem. This phase has been partially completed and is expected to be finalised by the end of 2019. The activities will include:
 - (i) considering recent articles and publication provided by known global business, economic, and accounting networks, publishers, and advisers;
 - (ii) collecting quantitative data relevant for intangible assets financial analyses and checking the increase in the relevance of intangible assets; and
 - (iii) conducting interviews to collect information on practices used to assess intangible assets by users of financial statements, contacting individuals and organisations that would have specific knowledge concerning the development of, and the risks associated with, the benefits obtained from, intangible assets.
 - (c) *Key Information Solution*: researching for possible solutions to the defined problems. This phase is expected to be finalised by the end of Q3/2020 and may include:
 - (i) categorising and describing the different types of assets and how their different features are relevant in terms of financial reporting. The categorisation may be based on the nature of the intangible (marketing, technological, social, reputational, or human capital), the industry or some other criterion; and
 - (ii) developing key indicators to express earnings potential and value. These may not fit as a measurement basis but could be used to disclose information in the notes.
 - (d) *Testing*: testing the identified solutions on different entities, including, if possible, testing with the European Corporate Reporting Lab. This phase is expected to be finalised by the end of 2020.
- 20 The EFRAG Secretariat will regularly update EFRAG TEG on the project status and seek its views as the Project develops.

Agenda Papers

- 21 In addition to this cover note, agenda papers for this session are:
- (a) Agenda paper 03-02 – Better information on intangibles – Definitions and issues – TEG 19-07-03; and
 - (b) Agenda paper 03-03 – Better information on intangibles – Current projects on intangibles – TEG 19-07-03.