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## **EFRAG's Research on Better Information on Intangibles Cover Note**

### **Objective**

- 1 The objective of this session is to inform the EFRAG User Panel and EFRAG TEG about the activities undertaken or considered for the research project and seek members' advice on how to foster and optimise engagement with relevant stakeholders.

### **Objective of the project**

- 2 The objectives of the EFRAG research project on intangibles are to:
  - (a) explain how entities, report on creating, maintaining and/or improving their value;
  - (b) explain how users, consume information on creating, maintaining and/or improving value, and the extent to which current financial reporting addresses their needs; and
  - (c) provide suggestions on how information on creating, maintaining and/or improving value can be provided in financial reports in a manner that is useful for decisions on providing resources to the entity.
- 3 In considering how an entity creates, maintains and improve its value, the project will focus on information on the entity's key intangibles. 'Intangibles' is to be consider broader than 'intangible assets' as it, for example, will include resources that are not controlled by the entity.

### **Previous discussions**

- 4 In April 2019, EFRAG TEG and User Panel members received an update on the project regarding the interviews conducted by the EFRAG Secretariat. Members concurred 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 attempt to fill the gap between the company's equity book value and its market capitalisation.
- 5 At its September 2019 meeting, EFRAG TEG further clarified that the research:
  - (a) should 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;
  - (b) should focus on financial reports (e.g. recognition and measurement of assets in financial statements and narrative information in the notes to the financial

- statements and in the management commentary) 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;
- (c) should aim to identify 'solutions' and good practices that would improve reporting on intangibles and better enable users to do their own assessments of intangibles; and
  - (d) should start by focusing on specific industries, rather than specific types of intangibles, covering more "intangible-intensive" industries, develop solutions and then consider if identified principles can be applied more broadly.

### Understanding users' needs

- 6 Understanding the information needs of users and fostering dialogue between preparers and users to identify issues and help solutions emerge was identified as a critical factor of success for the project. Agenda Paper 06 -02 includes the proposed interactions with users and preparers and seeks TEG and User Panel members' advice on how to foster and optimise engagement with users.

### What has been done and learned so far?

- 7 The EFRAG TEG has been presented with a summary of interviews performed by EFRAG Secretariat in February and March 2019. 16 interviews with academics, preparers, users, valuers and other professionals were conducted. In order to stimulate a broader discussion on the issues than just whether or not more intangibles should be recognised in the financial statements, these interviews did not focus on the accounting treatment for intangibles but more generally on whether there was an information gap and how this gap could be addressed. EFRAG TEG has also been presented with the feedback to the UK Financial Reporting Council's (UK FRC) recent intangibles consultation *Business Reporting of Intangibles: Realistic Proposals*.
- 8 According to the interviews performed by EFRAG and with the feedback received by the UK FRC on its consultation, users and investor have mixed views on whether IAS 38 *Intangible Assets* should be amended to allow the recognition of more internally generated intangibles. However, they were basically unanimous in their support for improving the quality of financial reporting on intangibles. Some noted the importance of focusing on those intangibles that are critical to the business model and value generation.
- 9 Some had concerns over information on intangibles being provided primarily outside the financial statements if this results in information not being audited.
- 10 Finally, users generally highlighted the importance of further outreach with investors, to ensure their information needs are clearly understood and that any proposals taken forward will meet those needs.
- 11 In February 2020 EFRAG published a commissioned [literature review](#) ('the literature review') on intangibles<sup>1</sup>. The literature review provided further evidence that only a limited number of studies have addressed how investors, analysts, and other users consume the information about, particularly unrecognised, intangibles, and the information needs of the users in that regard. 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 users to learn about their needs.

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<sup>1</sup> A presentation of the literature review is included as agenda paper 06-03 (for background information).

- 12 The literature review showed that:
- (a) Brands have a positive effect on financial performance, cash flow variability and market value of an entity. The same is the case for customer franchise.
  - (b) The amount of R&D expenditures is related to the number of patents, the number of patents related to the number of new products and the number of new products is related to performance. There is no direct link between the number of patents and performance – only indirectly as patents result in new products which improve performance. In US in the pharmaceutical sector patent share and patent position has been examined. The results show that the more an entity has spread its patents outside its most important technological field – i.e. the less it is dependent on one technological field, the higher the market price. However, in a given technological field the entity with the most patents has generally a higher market value than its competitors.
  - (c) (Good) reputation is also something that both affects the financial performance of an entity (positively) and increases the market value of an entity. Information about this is also found to be value relevant.
  - (d) R&D investments contribute positively to market value and performance – but more in the manufacturing sector than in the service sector. However, high R&D expenditures also result in a risk premium. Information about R&D is value relevant, however, one study shows that in high intangible intensive entities in the US narrative disclosures (in this case by disclosing patents) might be more useful than that resulting from capitalising the expenses related to these. The opposite is found for low intangible intensive entities. Additionally, voluntary, disclosures about R&D are found to provide information in addition to the information resulting from the figures in the financial statements. A study also shows that relevant information about R&D comes from other sources than the financial statements – particularly for intangibles intensive companies.
  - (e) Customer satisfaction and awareness is found to be linked to performance and customer satisfaction reduces systematic and idiosyncratic risk and lower the volatility in stock returns. However, financial results are relatively constant over broad ranges of customer satisfaction. A study also finds that customer satisfaction is not directly linked with financial performance. However, customer satisfaction is linked with reputation, which is linked with financial performance. Investigating customer satisfaction metrics in two industries telecommunications and airlines, a study finds that backward looking disclosures on customer satisfaction have little effect on users. Forward looking disclosures has a negative impact on investor's uncertainty – but the effect is only significant for the airlines.
  - (f) Customer list/customer franchise is found to be positively associated with stock price, future earnings and analysts' forecast errors.
  - (g) Some (generic) business models seem to be more profitable than others.
  - (h) Human capital (particularly together with brand capital) reduces cash flow volatility. Contrary to R&D, it creates relatively more value in service companies than in manufacturing and retail firms. Human disclosure is related with a firm's financial performance and market value. Companies can improve their valuation on the capital market in the long term by disclosing information on their human capital. Especially information on qualification and competence issues is positively associated with firm value.
- 13 The literature review summarised some of the models and/or frameworks that have already been developed to report on intangibles. Various frameworks have thus

already been developed but they are voluntary to apply and as they are different, entities that are voluntary applying different frameworks will provide different information.

#### **Future Consultations on EFRAG's Discussion Papers (DP)**

- 14 The outcome of the project is expected to be in the form of discussion papers discussing identified issues and possible solutions.
- 15 At this stage, the EFRAG Secretariat plans to issue by H2 2020 a publication on the current perceived issues with the information on intangibles in financial reports. The EFRAG Secretariat plans that the outlined content of this first publication will be discussed at the 25-26 March EFRAG TEG Meeting.
- 16 Finally, the EFRAG Secretariat plans to issue a discussion paper on possible solutions in 2021. Stakeholder (including users) would provide their inputs on the proposed possible solutions.

#### **Interactions with the Management Commentary Practice Statement**

- 17 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.
- 18 As a reminder and although no final decisions have been made yet by the IASB as to the exact content of the revised MCPS, it is expected that greater emphasis on information about intangible resources.
- 19 The IASB has clarified that the MCPS will remain a principle-based and 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.
- 20 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. The MCPS is also expected to identify some types of information that Users may need in specific circumstances.
- 21 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). The proposed guidance could be discussed but the Intangible Advisory Panel.

#### **Agenda Papers**

- 22 In addition to this cover note, the following agenda papers have been provided for the session:
  - (a) Agenda Paper 06-02 – *Issues Paper on Fostering Engagement with Users and Preparers*; and
  - (b) Agenda Paper 06-03 – *Presentation Academic Literature Review from December 2019 (for background purposes)*.