This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

# EFRAG's Research on Better Information on Intangibles

# Contents of the first discussion paper: identification of issues

## Objective

1 As part of EFRAG's research project on Better Information on Intangibles, it is planned to issue a paper ('the Paper') describing the issues with information on intangibles that is currently provided in financial statements, in the notes to the financial statements and in the management commentary.

2 The purpose of the Paper is to establish the inventory of the material issues relating to reporting on intangibles for the primary users of financial statements.

3 The objective of this session is to seek views from EFRAG TEG on the issues to be included in the Paper and ask EFRAG TEG if it considers that issues are currently missing from the Paper.

4 The structure of the Paper will follow a concentric approach (referred to as 'circles' below) for categorising the issues. The Paper will thus consider:

(a) The issues associated with current accounting framework and the case for reforming recognition, measurement and disclosure requirements for intangible assets.

(b) The need for meaningful financial information on drivers of value for intangible resources that would not be within the scope of IAS 38 *Intangible Assets* as the resource would not meet the definition of an asset (e.g. because it is not controlled by the entity).

(c) The broader consideration of the interaction between financial and non-financial information. In this context it would be information about factors that could affect an entity's intangible resources.

## First circle: Issues associated with the current accounting framework in IAS 38 *Intangible Assets*

The key accounting problem to be addressed is the question whether the recognition criteria in the Conceptual Framework and in IAS 38 are outdated and too restrictive (or too loose). This includes whether the control, identifiability and separability criteria are too restrictive (or too loose).

5 The interrelated potential[1] issues identified with the current accounting framework in IAS 38 are:

(a) Studies show that the value relevance of financial statements is decreasing;

[1] Not everybody would agree that there is a problem related to all the issues listed.

(b) Because many internally generated intangible assets are not recognised, it is argued that financial statements no longer reflect the underpinning drivers of value in modern business;

(c) Not recognising many types of internally generated intangible assets distorts performance measures;

(d) The fact that recognition of intangible assets depends on how the asset has been acquired reduces comparability;

(e) The reliability and relevance of some separately recognised intangibles acquired in a business combination is questioned by some users. Evidence of that was provided during the joint TEG-User Panel meeting in early March;

(f) Measurement at cost may be problematic and does not reflect the value of intangible assets, but measurement at fair value may also be problematic.

6 These potential issues are further explained below. Before that, it may be worth mentioning that the problems with accounting for intangible assets may not arise from the fact that they are ‘intangible’ but from the specific characteristics that are often associated with intangible assets: scalability, sunk costs, synergies and spill-overs.

*Financial statements no longer reflect the underpinning drivers of value in modern business*

7 Academic studies have shown that the value relevance of financial statements is decreasing.

8 Current guidance in IAS 38 *Intangible Assets* does not permit the recognition of certain internally generated intangible assets and does not require disclosure about unrecognised internally generated intangible assets or value creation activities.

9 The importance of intangibles is growing in the global economy where intangible assets such as big data, customer relationships, brand, efficient business processes, or the dynamic capability of a workforce, are an important part of how businesses create value.

10 Concerns are expressed that information in financial statements no longer reflects the underpinning drivers of value in modern business. Users are increasingly obtaining their information on intangible assets from sources other than IFRS-compliant financial statements and this can undermine the relevance of IFRS information.

*Distorted performance measures*

11 Some consider that not recognising most types of internally generated intangible assets distorts the measurement of an enterprise’s performance (including how income is matched with the related expenses) and does not allow an accurate assessment of returns on investment in intangible assets and capital allocation decisions. Poor information on intangible resources may affect:

(a) Company’s stock market performance and financial position;

(b) Capital allocation and investment decisions of capital providers;

(c) Access to finance for investment in intangibles;

(d) Information asymmetry;

(e) Stewardship (the accountability of management for actions/decisions in managing a firm’s resources).

12 Information about unrecognised internally generated intangible assets and an entity’s other value creation activities is important to users as it provides insight into a company’s ability to generate future profits and cash flows.

13 Some therefore consider that there is insufficient recognition of internally generated intangible assets.

14 Although some consider that it is problematic that so few internally generated intangible assets are recognised in the financial statements, others consider this to be of less importance as the future entity's profitability will reflect the cash flows generated in the relevant period by such intangible resources. Also, some finds that too many intangible assets are recognised in the financial statements; in particular in the context of business combinations.

*Comparability issue*

15 How an intangible asset has been acquired determines how it is accounted for. A particular intangible asset may thus be accounted for differently depending on whether it is internally generated, has been acquired separately or acquired in a business combination. In addition, not all items that meet the definition of an asset in the *Conceptual Framework for Financial Reporting* are recognised as such:

(a) Unlike IAS 38 and IFRS 3 *Business Combinations*, the Conceptual Framework's asset definition does not require the asset to be 'identifiable' or 'separable'.

(b) Under IAS 38 a probability recognition criterion applies, however under IFRS 3 this criterion is always considered to be satisfied.

*Reliability issue*

16 Is the separate recognition of intangibles in business combinations always providing useful and reliable information? Some users question the usefulness of the information resulting from the separate recognition of intangibles in business combinations (this appears from User Panel discussions, feedback to the UK FRC DP *Business Reporting of Intangibles: Realistic proposals*). In their experience, analysts rarely look at the values accounted for as they are highly judgmental.

*Measurement issue*

17 Investment in intangibles is associated with high levels of uncertainty. There is a time lag between investment in intangibles and economic benefits.

18 Both measurement at cost and at fair value may be problematic:

(a) For fair value measurement, an issue is that there is no active market for most intangibles.

(b) For measurement at cost, the issue is that it can be difficulty to identify / allocate internal cost.

19 Mismeasurement of intangibles at the entity level might have adverse economic effects to the extent that the existing requirements result in providing inadequate information.

20 In relation to measurement, the question therefore also arises when qualitative disclosures would provide more useful information than recognition and measurement.

**Second circle: Reporting meaningful financial information on drivers of value for intangibles that cannot be recognised?**

21 Not all intangible resources that are important for how an entity creates, maintains or enhances value would meet the definition of an asset. For example, because the resource would not be controlled by an entity or because it is not separately identifiable.

22 In some cases, it may also be difficult to apply the concept of control over the asset - when they are not protected by legal rights it is difficult to restrict access or protect the use by legal means.

23 For intangible resources that would not meet the definition of an asset, or would not, for other reasons, be recognised, quantitative and qualitative disclosures could be considered either in the notes to the financial statements or in the management commentary.

24 Feedback from users also provides evidence that the solution is not to recognise all intangibles in order to reconcile net asset value and market capitalisation but rather how to provide information on a company's intangible value drivers and how they support and impact the performance.

25 If internally generated intangibles are not recognised there is a need for useful information on value drivers to adjust measures such as:

(i) value measures (e.g. market-to-book ratio) that are biased;

(ii) performance measures (ROE, ROA, EVA) that are deceptive; and

(iii) the prediction of future earnings and cash flows, that is largely flawed.

26 Different categorisations of intangibles could be considered to identify the nature and level of information to be provided. For instance:

(a) Productive intangibles (e.g. drug patent of a pharmaceutical company) could be distinguished from 'finished goods' intangibles (E.g. consumer-ready television series rights or software programs).

(b) Sellable intangibles (e.g. consumer-ready television series right or developed software) could be distinguished from non-sellable ones (E.g., key staff, a company's knowledge and reputation).

*Issues with KPIs*

27 A potential solution could be to provide KPIs for intangibles that are not recognised.

28 However, there are also issues related to KPIs:

(a) There is a lack of common definitions of KPIs. This affects comparability between entities and industries and could also affect at least the perceived reliability of the information provided.

(b) Relevant KPIs are likely to be entity or industry-specific. This also affects comparability and makes it more difficult to develop common definitions of KPIs. It also raises the question of whether to rely on voluntary disclosures or introduce mandatory requirements.

(c) The reliability of the information could also be questioned as it could be impacted by embedded assumptions, potential management bias, lack of independent challenge and inconsistencies across business.

*Issues with qualitative disclosures*

29 In addition to, or instead of, quantitative information in the form of KPIs, qualitative disclosures could be provided. As for the KPIs, the comparability and reliability of the information could be questioned. Comparability would also here involve how resources are defined/categorised.

30 Furthermore, it should be considered that entities could be reluctant to disclose information which they consider could be used by competitors.

*Sensitivity analyses and disclosures*

31 The concluding remarks of the literature review on intangibles issued by EFRAG earlier this year identified that a key issue about reporting on intangibles is uncertainty:

(a) *“Investment in intangibles is associated with high levels of uncertainty. Further, while there is evidence that investment in intangibles leads to innovation and tangible investment, there is a time lag between intangible investments and economic benefits (intangible investment occurs early in the product life cycle)”;*

(b) *“the more the system is grounded on intangibles, the more vulnerable it becomes because intangibles are more uncertain, unstable and risky. The challenge we accountants face is to learn how to manage and report on these “invisible” resources for a better understanding of organisations’ financial performance and their resilience”.*

*32* There are known areas of reporting for uncertainties in the IFRS literature, such as the sensitivity disclosure in IFRS 7 *Financial Instruments: Disclosures*, IFRS 13 *Fair Value Measurement*, IAS 19 *Employee Benefits* and IAS 36 *Impairment of Assets*.

*33* Similarly, in the non-financial reporting literature the potential of disclosing information using scenario analysis is becoming more and more important.

*34* This topical area may be placed either in the second or in the third circle of the research as it may pertain to both.

**Third circle: Non-financial information regarding intangible assets or related factors**

35 The research project will consider non-financial (or ‘pre-financial’) information contained in corporate reports that would be relevant for assessing the entity’s (future) financial performance.

36 For such information to be considered, it would need to be ‘material’ information that is reasonably expected to influence the decisions of the primary users of financial reports. Following the recommendation made by EFRAG TEG at a previous meeting, the intention is not to have a broad look at non-financial information.

37 According to research, information about intangibles is prevalent among non-financial reporting items identified by analysts as being useful[2]. In addition, intangibles disclosure can help analysts answer specific questions about the innovation capacity of companies or their human resource strategy. Indeed, analysts often focus on certain types of information about intangibles that might be relevant to answering their particular questions.

38 For the purposes of the Paper, this section of the research will review the status of the ongoing European debate about non-financial reporting and integrated reporting, without any ambition to further engage in that debate.

39 A collateral product of this section of the research, will be the EFRAG input into the IASB consultation on Management Commentary Practice Statements.

40 We report in the paragraph below some initial considerations on the process for this section of the research.

[2] Intellectual capital and the capital market: a review and synthesis - Abhayawansa, Gurthie, 2010.

*Obstacles to overcome*

41 Growing consensus that better reflection of intangibles is required in non-financial reporting in order to improve its relevance to users. However, despite this active interest, progress appears weak.

42 Obstacles include lack of harmonisation of reporting standards, legal and regulatory risks associated with increased disclosure to companies and auditors, the cost of disclosure to companies, as well as a growing interest in other types of reporting in the investor community.

43 The variety of reporting frameworks and lack of standardisation in the reported information remains a major challenge, especially for less sophisticated investors[3]. The lack of standardisation affects comparability and reliability.

44 Many different models for reporting such information (e.g. WICI or IIRC) exist but do not seem to have found a large rate of adoption by companies, investors and professionals.

45 Most frameworks developed to date favour a qualitative approach where information about intangibles is reported in narrative format – either in the form of an intellectual capital statement or interspersed in extra-financial reporting – to complement financial reporting. Analysts appear to favour quantifiable information on intangibles that can be readily and easily integrated in their financial valuation models. But non-financial disclosure can help analysts answer specific questions about the innovation capacity of companies or their human resource strategy.

46 In relation to this project, additional issues regarding non-financial information that is relevant for assessing the entity's (future) financial performance is how to limit the information that could be considered relevant. In the end, (almost) everything could be said to have a potential impact on the entity's financial performance (for example, if it would affect the entity's reputation).

47 One method could be only to consider the non-financial information that would be expected to be relevant for an entity's core intangibles. An issue with such an approach would however be, how to identify core intangibles.

*A potentially wide range of sources of information to consider*

48 Besides Financial Statements and Management Commentary, information about intangibles provided by entities may be located in a wide range of places:

(a) Narrative information elsewhere in the annual report;

(b) Information that has been collected for commercial sale;

(c) Information on intellectual property, technology, patents and trademarks;

(d) External estimates of brand value/recognition;

(e) Voluntary disclosures on research and development activities; pipeline of new products;

(f) Marketing-related indicators such as page views or subscriber base statistics;

(g) Organisational indicators on training, quality targets, productivity, personnel features, and employee engagement and attrition;

(h) ESG disclosures;

(i) Strategy and strategic alliances with other entities;

[3] The EFFAS Commission on Intellectual Capital (2008) noted that standardisation and reliability are vital in developing KPIs that are useful for the financial community.

(j) Information on customer and supplier markets, reputation, customer satisfaction and loyalty/ repeat business;

(k) General business macro-environmental information;

(l) Industry-based KPIs; media and broker reports; sharing information with other investors;

(m) Company visits to ascertain culture and quality of management;

(n) Direct engagement with senior management.

49 In identifying ways to improve current reporting practices in financial reports (Financial Statements and Management Commentary), the research may have to look at a larger set of documents and publications in order to identify information that is useful to primary users and could be repatriated in financial reporting.

*Leveraging on existing initiatives*

50 A number of recent initiatives and consultations by the European Commission, the International Accounting Standards Board (MCPS), the International Corporate Governance Network and other bodies have focused on enhancing standards for narrative reporting.

51 EFRAG will consider the extent to which these initiatives can inform its own research.

**Resources/obligations and risks/opportunities**

52 The first and second circles will focus on intangible resources (potential future benefits) and will not consider potential liabilities.

53 The third circle may be seen in two possible ways:

(a) positive and negative factors that may impact the value of recognised and unrecognised intangible resources;

(b) risks and opportunities that may impact current or future financial position/performance.

54 For the purposes of EFRAG research, we will consider only (a) above.

**Questions for EFRAG TEG**

55 Has EFRAG TEG identified any additional material issues relating to reporting on intangibles for the primary users of financial statements than those identified above?

56 Does EFRAG TEG have any comments to structuring the Paper on the issues relating to reporting on intangibles as suggested in paragraph 4?

57 With reference to the dimension of the analysis described in paragraphs 52 to 54 above, does EFRAG TEG agree with the proposed approach?