EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium

June 30, 2022

Re: **EFRAG Discussion Paper *Better Information on Intangibles* – *Which is the Best Way to Go***

Dear EFRAG,

We are pleased to provide comments on EFRAG's Discussion Paper *Better Information on Intangibles.*

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We would be pleased to discuss our comments with the EFRAG staff. Please reach out to Greg Franceschi at greg.franceschi@kroll.com, Marianna Todorova at marianna.todorova@kroll.com, or Gary Roland at gary.roland@kroll.com with any questions.

Sincerely,

Kroll

Office of Professional Practice

Kroll

Kroll, LLC
1950 University Circle
Suite 400
East Palo Alto, CA 94303

T +1 650 798 5570
F +1 650 798 5510

greg.franceschi@kroll.com
www.kroll.com

Comments

We have read with great interest the Discussion Paper *Better Information on Intangibles – Which is the Best Way to Go* (the "DP") and find impressive EFRAG's comprehensive approach in analyzing the issues.

As the present-day economy is overwhelmingly driven by information and intangibles, we believe that recognition – and not just disclosure – should be given to many classes of internally developed intangible assets.

Our feedback below is intended to address a few limited aspects of the paper, hopefully helping in future discussions on the topic. We have grouped our comments into two main themes.

I. Perspectives in analyzing intangibles

We believe that an important perspective that should not be overlooked when analyzing intangible assets is the slightly different focus on assets acquired in a business combination vs. created as part of the ongoing business:

- In a business combination, recognition is being given to assets that have already been created (i.e., commercialized) as of the date of the business combination (except for IPR&D), and which provide a current economic benefit. They are measured at fair value considering their respective condition/functionality as of their date of purchase (the acquisition date).
- In the ongoing course of business, recognition (through capitalization) would be given to intangible assets still being developed, as well as to the continuous maintenance and enhancement of already created and functional assets. In other words, in this case, the approach and resulting picture are more fluid.

  We agree that recognition in this case could involve the capitalization of costs with future benefits as a proxy for assets that analysts might view as an element of invested capital. This would also be a step towards narrowing the gap between a company's book value and its market valuation. The capitalization approach can be coupled with a fair value impairment model, to be applied when certain impairment indicators are present. Perhaps this could also be supplemented with periodic fair value disclosures for certain assets, in addition to other ongoing disclosures.

A second helpful distinction to make is between intangibles that are the *result of the value creation process at the company* vs. *intangibles that create such value*. These are also two different perspectives which are equally important in understanding the nature of the operations and the value of a company:

- The first category would include assets such as technology, patents, and brand names.
- The second category would include assets such as human capital, processes, and institutional knowledge[1]. This concept is partially touched upon in paragraph 1.21 of the DP which states:

  > "…the term 'intangibles' is thus used 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 financial reports, and whether or not they would meet the accounting definition of an asset."

  Interestingly, the second category is also the one more closely aligned with the types of intangibles for which the company has few, if any, control rights, as described by the DP (par. 3.1, Category C). Accordingly, this category is for the most part – except for customer-related assets, and at times, certain supplier, and other relationships – subsumed in goodwill. Yet, these are the types of intangibles that have an intrinsic capability for continuous value creation, especially in a knowledge-based economy. These intangibles also have the most direct linkage to ESG factors. Therefore, more, rather than less information is needed about such intangibles, notwithstanding the issue of 'control rights.'

We hope that these distinctions are helpful in advancing future discussions on this topic.

II. A holistic approach to the accounting for intangibles should not narrow the intangible asset types currently recognized in a business combination

Current set of intangible assets recognized in a business combination

While a holistic approach to the accounting for intangible assets should be pursued, we believe this should not come at the expense of the types of intangibles currently being recognized in a business combination. Subsuming intangibles – or a subset of currently recognized intangibles – into goodwill will eliminate significant value-relevant information. In addition, we believe that more disclosure about intangible assets, while being helpful supplemental information, is not an alternative for their fair value measurement.

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[1] This can also be characterized as institutional understanding (such as human capital, informational capital, and organization capital), as described in Kaplan, R., Norton, D. ed. (2004) *Strategy Maps: Converting Intangible Assets into Tangible Outcomes*. Boston: Harvard Business School Publishing Corporation.

Purchase accounting is a unique circumstance in which greater visibility is afforded into intangible assets that are often critical to the success of a business. Investors get insight into the nature and value of the assets purchased in the transaction and can gauge the relative uncertainty of future cash flows. The recognition of purchased intangibles at fair value also helps assess management's acquisition decisions, as well as its subsequent performance. In the end, the purchase price allocation process explains what investments have been made as part of the transaction, considering the company's business model, value drivers, competitive dynamics, and sources of competitive advantage. In many cases such investments in intangible assets made as part of a transaction are material.

Standard-setters and various stakeholders have so far been in overall agreement about the usefulness and operability of the business combination standards and the recognition of intangible assets in acquisitions. For example:

- The IASB's preliminary view in their 2020 discussion paper, *Business Combinations – Disclosures, Goodwill and Impairment* was that it should not develop a proposal to allow some intangible assets to be included in goodwill. The existing guidance for the separate recognition and measurement of identifiable intangibles is appropriate and operational. Most respondents to the IASB's discussion paper agreed with the Board's preliminary view that it should not develop proposals to include in goodwill some separately identifiable intangible assets recognized in a business combination. In their view, the separate recognition of these intangible assets provides useful information, and they did not see a need for a change.

- In addition, overall, respondents to the FASB ITC on *Identifiable Intangible Assets and Subsequent Accounting for Goodwill* opposed changing the current guidance for the recognition of identifiable intangible assets. Further, in a recent meeting in June 2022, FASB removed from its active standard-setting agenda its project on *Identifiable Intangible Assets and Subsequent Accounting for Goodwill*, which would have considered making changes to the recognition of some intangible assets currently recognized in a business combination.

- The CFA Institute also made it clear that deviating from the current recognition criteria for intangible assets in a business combination would decrease the value relevant information in the financial statements.[2]

[2] CFA Institute Comment Letter on FASB's ITC on *Identifiable Intangible Assets and Subsequent Accounting for Goodwill*.

Acquired intangible assets for which markets do not exist

The DP makes note of certain assets for which "markets are weak or non-existent (DP par. 3.1, Category B and Category C), including R&D in process; non-patented technology; trade secrets; customer, supplier and other relationships.

In this regard, it is critical to recognize that assessing the merits of an intangible asset solely through the lens of whether it can be sold or separated from a business, or transacted outside of a business acquisition, falls short of conveying the importance of the asset used in an ongoing operation. Such a narrow approach would fail to capture the economic value associated with many intangible assets (such as the ones listed above), as the premise of value creation in a business (and even in certain asset groups) is 'in use/in combination with' other assets. Thus, we do not believe it is appropriate to consider acquired intangible assets on a standalone basis when evaluating their recognition.

Acquired customer-related intangible assets

Acquired customer-related intangible assets (CRIs) are of particular interest given the issues raised in the DP about "few, if any, control rights" that a company has over such assets and that "markets do not exist" for them (DP par. 3.1, category C).

CRIs are key assets in many industries, including but not limited to, defense contractors, cable, and technology companies. In these industries, existing customer contracts are critical intangible assets and the fair value of the backlog of contracts in place (and expected renewals) provide a meaningful indication of contracts in hand as opposed to those that have yet to be won. In many instances, the existing customer contracts and relationships are the key reason for the decision to acquire the target, and therefore represent a meaningful purchased asset. Retention metrics are key operating indicators in these industries, and the data underlying these metrics is very robust. Many deal models include explicit assumptions about retention/renewal rates of customers – for example, in Software as a Service (SaaS) acquisitions. Additionally, expected retention/renewal rates are real value-driving considerations as they affect the risk of the target and the discount rates used in the deal models. Thus, existing customer contracts and contract renewal expectations provide relevant and decision useful information about expected cash flows and their risk.

Further, the way companies interact with their customers and leverage customer information has changed dramatically in the modern information age. For example, the retail and consumer products industry has been utilizing customer contact information (email and text) to track customer behavior and predict and drive future customer revenue. This is a critical new strategy in these industries, which shows that CRIs have further evolved in importance.

In summary, narrowing the recognition criteria for intangibles to exclude assets such as acquired CRIs would significantly limit the useful information provided in acquisitions.

Acquired supplier or other relationships

Many of the arguments stated in the preceding section on CRIs also apply to supplier relationships. In certain situations, supplier agreements and relationships are much more than a cost of doing business, and an acquirer places a value on such assets due to either scarcity or an off-market component inherent in the arrangement. For example, in the chemicals distribution industry it is not uncommon to value supplier relationships – these distributors are the 'bridge' between the major producers of chemicals and the small end-customers. Often the distributors are working on an exclusive basis with the major producers of chemicals and as such, the supplier relationships/distribution rights would be recognized as a key intangible asset. Not recognizing and ascribing value to such acquired contracts or relationships, when appropriate, would limit the utility of information provided in acquisitions.

Maintenance and replacement of internally generated intangibles

DP par. 2.5 b), (iii) states that "the statement of performance is 'hit twice' in the same period if an entity acquires an intangible asset (which is capitalized and amortised) and replaces this over time with an internally generated asset which cannot be recognized and for which the costs are therefore recognized in the financial statements at the same time as the amortization costs of the acquired intangible assets".

We believe that in the above case, the amortization charge appropriately recognizes the contribution of the purchased intangible asset as it provides current utility to the company. In this sense, the outcome is the same as having a purchased tangible asset that is capitalized and depreciated. If any adjustment is required in improving the information presented in the statement of financial performance, the argument points to the need to capitalize and amortize the internally generated intangible assets.

We also often observe that some constituents incorrectly believe that the amortization charge for an acquired intangible asset double counts the related future maintenance expenses for the asset. This is a misconception. Acquired intangibles are valued net of maintenance expenses (e.g., ongoing marketing expense for an existing brand); thus, the amortization charge does not double-count such ongoing future maintenance expenses.