Project Update: Intangibles Qualitative Research

Executive Summary

Project type	Thought leadership
Project scope	Significant
Purpose of the paper	
This paper provides an update on the current status of the Intangibles Qualitative Research project and outlines the expected timeline for completion of the report.	
Summary of the issue	
As set out in the Project Initiation Plan (PIP) approved in July 2022, the UKEB project team has been working on a report into stakeholder views on accounting for intangibles, drawing primarily on qualitative research based on in-depth interviews with a range of stakeholders, supported by a review of key literature. The stakeholder interviews and analysis of relevant academic papers are now complete. Key findings to-date are that stakeholders are looking for a substantial overhaul of the accounting for intangibles from IAS 38 *Intangible Assets,* with the objective of providing greater recognition and enhanced information about companies' intangible items. Due to constraints on the Board's agenda, a draft report is scheduled for the October meeting. An amended PIP, reflecting feedback from the UKEB October meeting and clarifying project steps in compliance with the final Due Process Handbook, is scheduled for the November meeting. We do not believe this will impact the UKEB's ability to influence the IASB project given their current timeline. We have had ongoing discussions with EFRAG staff about our findings to date, who requested that we share any key findings with them in October.	
Decisions for the Board	
The Board is asked for comments on the update and the proposed timeline.	
Recommendation	
This paper provides an update and there are no recommendations for the Board.	
Appendices	
None	

Background

1. The increasing importance of intangibles to the modern economy is ubiquitously acknowledged, as demonstrated by the numerous academic papers and books written[1] on this topic. As noted by CPA Ontario "Today, intangible assets are recognized as the key source of innovation and growth, an economic golden goose"[2].

2. At the same time, there has been significant discussion about the shortfalls of IFRS standards in relation to accounting for intangible items. For example, Steve Cooper, an independent analyst, former IASB Board Member, and co-author of The Footnotes Analyst blog, has stated that, "the current inconsistent and limited recognition of intangible assets causes analytical challenges for investors… We think that investors would greatly benefit from improvements to both the narrative reporting and financial statement data regarding intangibles."[3]

3. The IASB has acknowledged these concerns about intangible assets. In one of his first public statements the new chair of the IASB, Dr Andreas Barckow, stated that "the rise of self-generated intellectual property and its non-addressal in the accounts"[4] was one of the biggest challenges and opportunities facing the IASB.

4. In April 2022, the IASB confirmed that a research project on intangible items would be one of three projects to be added to their work plan after the completion of the third agenda consultation.

5. The IASB staff paper[5] stated that:

   "[an intangibles] project should aim to comprehensively review IAS 38. Although developing enhanced disclosure requirements (such as disclosures about unrecognised intangible assets) would help to address user information needs, feedback indicates that other aspects of IAS 38 also should be reviewed. For example, respondents said that IAS 38 is an old Accounting Standard in need of modernising to reflect the increasing importance of intangible assets in today's business models."

6. The IASB website currently states that, "This project will aim comprehensively to review the accounting requirements for intangible assets. Initial research will seek to identify the scope of the project and how best to stage work on this topic to deliver timely improvements to IFRS Accounting Standards."[6] To date no specific timeline is provided.

7. In early 2022, the UKEB agreed to undertake a multi-output, proactive research project that would contribute to the international debate on Intangible items. The research is to focus on how the accounting for, and reporting of, Intangible items could be improved

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1 See for example "Capitalism Without Capital – The Rise of the Intangible Economy" and "Restarting the Future – How to Fix the Intangible Economy" both by Jonathan Haskel and Stian Westlake.

2 CPA Ontario | Intangibles

3 Missing intangible assets distorts return on capital | The Footnotes Analyst

4 IFRS - Meet the new IASB Chair—Andreas Barckow

5 AP24A: Projects to add to the work plan (ifrs.org) (see Paragraph 35)

6 https://www.ifrs.org/projects/pipeline-projects/

to provide investors with more useful general purpose financial statements to assist them to make better informed decisions[7].

8. The initial phase of the research is focused on understanding stakeholder views (particularly investors) of the accounting for, and reporting of, intangibles in the UK. This involves three outputs:

   a) A report drawing primarily on qualitative research based on in-depth interviews with a range of stakeholders, supported by a review of key literature. The research is explorative by design. It will provide a better understanding of UK stakeholders' perspectives on the accounting for, and reporting of, Intangibles in the UK, and the economic outcomes arising from the existing accounting framework. It will also form the basis for later research that will provide more explicit recommendations to the IASB. This research will also be brought to the attention of EFRAG, in response to its Better Reporting on Intangibles project. This report is the focus of the current board paper.

   b) A report, and recommendations, based on more comprehensive investor outreach, further developing the learnings from the early qualitative research. The primary research will be based on outreach with investors, including interviews and a survey.

   c) An analysis of Intangibles Reporting in the UK, focused on estimating the prevalence and economic relevance of intangible items among UK reporters, an analysis of current practices among listed UK companies using IFRS standards, including capitalisation and expensing, along with associated disclosures. An analysis of whether and how current reporting practices affects economic outcomes may also be conducted.

Current Status of the Qualitative Research Report

9. Interviews with over 30 stakeholders and review of relevant academic research are now complete. The drafting the report is currently underway and an outline of the structure of the report is provided at Annex 1 to this paper.

10. Our findings remain consistent with what we reported to the Board in July: stakeholders are looking for a substantial change to the accounting for Intangibles from IAS 38 *Intangible Assets* that will provide greater recognition of, and enhance the information provided about, intangible items.

Concerns with current accounting

11. Many stakeholders identified inconsistencies with the Conceptual Framework which has been updated a number of times since IAS 38 was first issued. Specifically, IAS 38 requires expenditure to meet a different definition of "asset" and "control" from that in the Conceptual Framework. This means that the standard no longer reflects current thinking on what constitutes an asset and therefore does not adequately capture key intangibles that many entities are generating.

7 Intangibles Project | UK Endorsement Board (endorsement-board.uk)

12. IAS 38 requires many specific types of internally generated intangibles to be expensed. These include marketing expenditures, internally generated brands, training, customer lists and similar. Almost all stakeholders commented that this prohibition from capitalisation of expenditure that could otherwise be deemed as contributing to an intangible asset fails to capture useful information about many intangible items.

13. There are significant differences between the accounting for internally generated intangible assets (frequently expensed), acquired intangible assets (which use a cost model) and intangible assets acquired through a business combination (which use a fair value model).

14. Stakeholders commented that this leads to significant differences in the accounting for otherwise comparable companies, dependant on whether they have grown organically or through acquisitions.

15. While there are a substantial number of disclosure requirements for recognised intangible assets under IAS 38, there are virtually no requirements related to intangible expenses. Given that most internal expenditure on intangibles is currently required to be expensed, we heard numerous comments that the current requirements are inadequate.

16. Stakeholders also identified a range of additional disclosures they believe would enhance the usefulness of information about intangibles. This enhanced disclosure reflects the importance of intangibles and the potential uncertainty around their value to the organisation. These are discussed below.

17. Most stakeholders wanted any new standard for intangibles to recognise and capitalise a greater range of expenditure, potentially including research, training, and certain marketing expenditure in some circumstances.

Opportunities for improvement

18. Many stakeholders were generally comfortable with capitalisation of many costs associated with intangibles, particularly where there were clearly identifiable rights attached to the associated intangible item. They view this as an important step in addressing the issues of standard inconsistency and differences between organic and acquisitive growth.

19. During discussions, most stakeholders agreed that accrual accounting, which would not only capitalise costs but would also require amortisation (tied to a reasonable useful economic life) and impairment, would provide more relevant and reliable information.

20. A number of users were wary of over-capitalisation of internally generated intangible assets, particularly where there were no clear legal rights that provided certainty over the existence of an asset.

21. An emerging issue relates to separating costs that are more like operating expenditure (and should be expensed) and those that are more like capital expenditure (and should be capitalised).

22. Feedback on use of fair value for measurement purposes was more mixed. Some stakeholders thought there should be more fair value measurement of intangibles. However, there was a general acknowledgement that this would increase variability in the financial statements, as valuations of intangibles are likely to become more volatile.

23. Preparers were concerned that users of financial statements would over-react to such fluctuations. Users of financial statements were concerned that fair value would make it more difficult to understand the financial statements, particularly where markets were less active or non-existent.

24. A majority of stakeholders observed that disclosure requirements related to intangible expenditures that are not capitalised must be enhanced. They want more granular information about the nature of expenditure, including but not limited to specific information on marketing, IT, training, and research.

25. Stakeholders want to understand the relationship between such expenditure and the organisation's business model. Further, they request information on whether the entity is expecting to maintain or enhance future cash flows.

26. Most stakeholders commented on the need for enhanced disclosure on intangibles, though only a few thought that enhancing disclosure alone was enough.

27. For many investors (as opposed to stakeholders more generally) improved disclosures was their primary recommendation with regard to accounting for intangibles. However, when the possible alternative approaches were discussed, there was often agreement that more could be done to improve the accounting in terms of recognition, measurement and disclosure for intangible items. Only a few thought that enhancing disclosure alone was sufficient.

28. Many stakeholders talked about the need for enhanced disclosure on risks associated with capitalised intangibles to compensate for the greater uncertainty about their value.

29. They also believed there could be more information linking intangibles to related Key Performance Indicators (KPIs). This would help address concerns about over-capitalisation. For example, management could link useful life and impairment directly to the drivers of value intangibles are expected to provide. As one user noted:

   "A number of stakeholders thought that information on these key drivers would be central to future ESG reporting, and that these relationships would be important to highlight and would provide particularly useful information."

Materiality matters

30. The issue of materiality was raised in many interviews. Most stakeholders interviewed wanted increased granularity of disclosure. It was observed that intangibles are important drivers of value, but carry increased risk and uncertainty, and so greater disclosure and finer detail would be required to help users of financial statements assess their impact.

31. Stakeholders were asked how this could be balanced with concerns about information overload. Most felt that for intangibles qualitative factors are more important than

quantitative ones. These qualitative factors are likely to be derived from the relationship between the intangible item and its importance to the business model.

32. In this context some stakeholders expressed concerns about commercial sensitivity, but again stakeholders identified materiality as the overriding factor.

Ways forward

33. Some clear directions are beginning to emerge and will be picked up as part of the next steps for this project. These include

    a) Any new standard on accounting for intangible items should be developed in a way that is "future proofed". So, rather than focussing on specific types of intangibles currently common in companies, it should take a broader approach that will be relevant for both intangibles that exist today, and that may emerge in the future. The approach will also need to address the development over time of legal and other rights as well as related markets.

    b) Two key elements that should drive the accounting seem to be emerging:

        i. The use of the item (or alternatively its relationship to the business model). The accounting for intangible expenditure related to items contributing to the operations of the entity may be different from those that are being developed to create new opportunities for the entity, or even those items that are being invested in for speculative purposes.

        ii. The strength of rights over the benefits that accrue from the expenditure. Expenditure on patents represents a strong right protected by patent law and the courts. Expenditure on brands (marketing) may represent a weaker right, though could be associated with trademarks. Related to this is also the quality of information available to support valuation of intangibles. The weaker the right over the intangible asset the more important disclosure becomes, and the more important it is that management can relate the expenditure to measurable outcomes or KPIs.

34. An appropriate accounting standard will balance measurement uncertainty with disclosure while harnessing all the informational benefits that accrual accounting brings, surfacing management information to overcome informational asymmetry. This includes better information on expected returns, useful life and value of assets.

Question for the Board
35. Does the Board have any comments on the high level findings to date as we finalise the draft?

Next steps

36. Due to constraints on the Board's agenda, a draft report is scheduled for the October meeting. An amended PIP, reflecting feedback from the UKEB October meeting and

clarifying project steps in compliance with the final Due Process Handbook, is scheduled for the November meeting.

37. The final report publication remains on schedule for December, and this should allow for feedback to be presented in Quarter One of 2023.

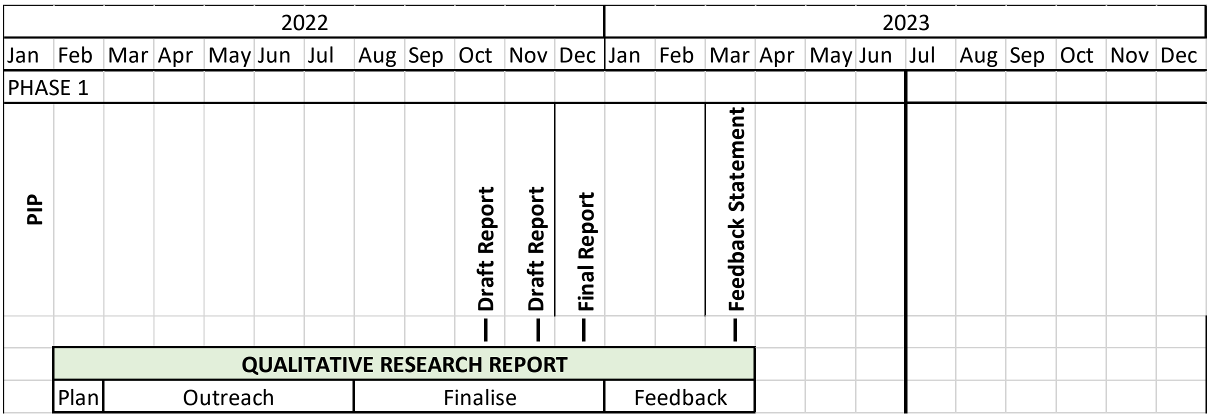
38. We do not believe this will impact the UKEB's ability to influence the IASB project given their current timeline.

39. We have had ongoing discussion with EFRAG about our findings to date, and have also notified them of our changed timelines. They have asked us if there are specific findings relevant to their Discussion Paper "Better Information on Intangibles"[8] that we would like to share that they would like to receive these in October.

Timeline

40. The following suggested timeline reflects the changes identified in this paper.

41. A more comprehensive timeline and revised Project Initiation Plan for the remaining Phase 1 of this project will be presented to the November meeting to incorporate learnings from the Goodwill research project and the Intangibles project to date. This will also incorporate changes to ensure that the timeline and outputs are in compliance with the UKEB's final Due Process Handbook.



Question for the Board
42. Does the Board have any comments on the proposed next steps and timeline?

[8] Better Information on Intangibles (efrag.org)

ANNEX 1: Qualitative Intangibles Research Report Draft Structure

Executive Summary

1. Introduction
    a) Accounting for intangibles
    b) Calls for change

The economics of intangibles

Specific concerns identified during the research

a) The Standard is Old
b) Limited recognition
c) Limited consistency
d) Limited Disclosure
e) Support for the current approach

Opportunities for improvement

a) Enhanced recognition and measurement
    i. Initial recognition and measurement
    ii. Subsequent recognition and measurement
    iii. Concerns with Enhanced recognition and measurements
b) Enhanced Disclosure
    i. Enhanced expense disclosure
    ii. Better understanding of risk
    iii. The role of the business model
    iv. Concerns with enhanced disclosure

Other Issues

a) Materiality matters
b) Prudence, relevance and reliability

Ways forward

Conclusions

Next steps

Appendix 1 - Research method

Appendix 2 - Summary of interviewees

Appendix 3 - Literature review