UKEB-IA220301

To: Pauline Wallace, Chair, UKEB

Dear Ms Wallace,

Thank you for the invitation to comment on your Regulatory Strategy 2022/23 with its inclusion of Intangible Assets in its Expected Workplan, both as an Influencing Project and in Research for thought leadership, leading to the PIP: Intangible Assets.

Having been contributing to work on Intangibles by a number of organisations, including projects of the FRC, the FRCLab, and the IASB since 2015, then more recently the UKEB, it has been very interesting to see the UKEB PIP: Intangible Assets, with its copious footnote references.

Whilst this PIP brings together many of the matters of concern increasingly expressed for several years by organisations and people, particularly the value of internally generated IP, there are a few matters which concern me that might also merit inclusion in forthcoming work.

Some of my concerns:

1. Classification of different specific intangibles: Specific intangibles may be too technically and/or commercially sensitive; maybe classes/types of key/core intangibles could be more widely acceptable.
2. In his discussion with the FRC's David Rule in the FRC's programme last summer Professor Karthik Ramanna advocated more challenge by accountants. Discussions of a wide range of topics are currently focussed mainly on investors, but could beneficially be more challenging if included other stakeholders. This could 'challenge' the accountants, etc. A source of challenge **to** the accountants, etc, as well as **by** accountants. It could be productive in extracting alternative perceptions from a wider external perspective on some of the intangibles and their value, with contributions to the UKEB research by the 'creators of value', such as scientists, engineers, medicine, pharma, etc. This should be in addition to contributions by professionals in the areas of finance, accounting, banking, insurance, etc, who are mainly the financial recorders, measurers and funders/facilitators of the value created. This could progress the FRC work which may have tended to be rather introspective and accounting profession based, whereas there could be benefit from more open thinking approach to <u>out</u>reach projects. See 'Major Output 2' survey of investors, and 'listed UK companies' in 'Major Output 3'; both should include such open thinking in outreach projects.
3. Under 'Risks' you observe that 'it has been difficult to engage with investors' – implying that they may not have the patience because of 'the time scales involved'; this may also apply to other 'key stakeholder groups' such as the 'creators of value' – who perhaps have not been invited to, included in, or listened to, for previous research projects.
4. The Project's timeline outlined under PIP's 'Key planning assumptions, etc' might benefit from re-examination and revision to more beneficially link with, and influence earlier, the work currently being carried out by IASB and EFRAG. 'A comprehensive report setting out the findings from the UKEB research project in late 2024 or early 2025' seems about two years too late to support the IASB activities 'commencing later in 2023'. More in line with the timing of your PIP 'Major Output 1' for influencing the EFRAG, four months hence in June.

5. There seems to occasionally be confusion/conflation of ‘research’ and ‘development’ into ‘R&D’ – which might alternatively be termed ‘innovation’; *inter alia* see EFRAG, ‘Better Information on Intangibles’, 4.19, p43. They are different:
    - ‘Research’ relates to investigation in order to establish new knowledge/conclusions, and its expenditure should be expensed in the statement of financial performance (P&L),
    - ‘Development’ relates to causing to grow and/or become more advanced, ie, after research, and its expenditure should be capitalised in the statement of financial position (B/S).
6. In allocating innovation costs to either expenditure or assets, the influence of capitalising expenditure on taxable company profits deserves consideration.

Attached, below, are my comments to the IASB for their ‘Third Agenda Consultation’ last year, which are more detailed than the contribution I made to the UKEB, because of the IASB’s more open approach by asking questions in preference to seeking comments on, and implied ‘endorsement’ of, your existing draft letter which rather constrained freedom of thought. Therefore, it was good to see your PIP Research Question in the ‘Objective of the project’, with its key elements being very open.

Thank you again for your invitation to comment.

Best wishes,

Chris de Nahlik
BEng, MBA, MA, CEng.

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<u>IASB, THIRD AGENDA CONSULTATION</u>, Request for Information.

Comments by Christopher de Nahlik, private investor. 27 September 2021

1. **Strategic direction and balance of the Board's activities**
   <u>Question 1</u>. Overall balance of IASB's main activities – *suggestions in italics.*

   (a) Should the Board increase, leave unchanged or decrease its current level of focus for each main activity?
   The overall balance of focus on each of the Board's six main activities, as illustrated in Diagram 3, and the comparative levels may well be appropriate; however, the relative priorities accorded to the separate activities may warrant review. Because it is essential that the Standards are used and applied as intended, *being understandable and accessible through engagement with stakeholders is the key enabler*; so, arguably, this is more important and urgent than supporting digital financial reporting – see also Q3, below.
   (b) Should the Board undertake any other activities within the current scope of its work?
   It is important *to include checking alignment/compatibility across/between Standards, and continued alignment of the Conceptual Framework* in the light of any changes to Standards that are thought appropriate; inter-Standards' inconsistency leads to confusion and consequently ineffective standards, which in turn can lead to misinterpretation and give scope for obfuscation.

2. Criteria for assessing the priority of financial reporting issues that could be added to the Board's work plan.

Table 2. The Board's proposed criteria.
The heading might better have been: The Board considers seven criteria in deciding whether to add potential *projects* to its work plan, *and whether to continue, remove, suspend, reinstate, or put on hold existing projects.*

Question 2. Criteria the Board uses when assessing the priority of financial issues that could be added to the Board's work plan.

(a) Has the Board identified the right criteria when assessing the priority of financial issues that could be added to its work plan?
The criteria's seven basic fields - importance; reporting deficiencies; company types, sectors and jurisdiction; pervasive or acute; projects' interactions; complexity and feasibility; capacity for progress - may be appropriate. But their ranking/priority may not be the same for all issues and might benefit from review in an attempt better to meet the nature and needs of today's business environment which differs across sectors, has changed since earlier Standards' reviews, and continues to evolve at increasing rates and changing directions. *Considerations* along the following lines may be worth thinking about:

1. The importance *and urgency* of ……(through stakeholder engagement – perceptions and judgement of report users prioritised over the preparers)
2. Whether there *are any deficiencies* ….
3. The type *and financial values* of companies, *and high and growing total value sectors* ….
4. How pervasive, *chronic* or acute the matter is likely to be, *or has been*, for companies….
5. Agree
6. and 7. Considerations of complexity (particularly if across several Standards), feasibility, capacity and timely progress must not be allowed to prevent, delay or suspend projects that meet other criteria, especially 1 and 2, but also 4 and 5. Otherwise this could be seen as limited capability to plan, manage and complete more challenging projects. Putting off the evil hour – procrastination is the thief of time!

(b) Should the Board consider any other criteria?
Not so much 'other criteria', but consideration to review their wording, as suggested in (a), above.

3. Financial reporting issues that could be added to the Board's work plan.

Question 3

(a) What priority would you give each of the potential projects described in *Appendix B* – high, medium or low? …. Please provide information that explains your prioritisation and whether your prioritisation refers to all or only some aspects of the potential projects.

Climate-related risks. High priority. This is a matter of globally accepted importance. I have no specific considerations to add.

Discount rates. Medium priority. This in relation to inflation and present value of the Intangible Assets (IA).

Inflation. Medium priority. Only as moderate inflation affects interest, Fair Value and Discount rates.

Intangible Assets (IA). High priority. (See Rationale also below)
This issue was considered but not included in the Board's 2016-2021 work plan Agenda, and having been told in 2015 that the matter was 'on hold'; it assumedly had been in the Board's first work plan agenda. Therefore, it would seem, there has been awareness by the Board of the need for either a major amendment or new Standard covering IA for a significant time – maybe 10 years or more - but the matter had been perceived as relatively unimportant. So, it is hoped that the Third Agenda's potential Intangible Assets project, in all its broad and deep complexity, will be taken off 'hold' and recommenced at the earliest opportunity at high priority.

Operating segments. Medium priority. Operating segments, or boundaries for reporting within companies, leads to contemplating business/industrial sectors. This would be useful for reporting subjects specific to sectors, and/or national jurisdictions, for better comparability of sector specific aspects of company performance, eg intangibles in technology based sectors' companies. This leads in turn to the possibility of defining 'sectors', such as the Financial Times Share Service page.

Appendix C, Other issues
Digital financial reporting. Medium priority
Fair value. Medium priority.
Goodwill and impairment. Medium priority.

For the other issues listed in Table 5, Potential Projects, I have no specific priority opinion to contribute.

Intangible Assets. International Accounting Standard (IAS) 38, ('the Standard'). High priority. Rationale:

i There has been increasing acknowledgement that medium- to high-technology, science, etc, sectors' companies, but also some other sectors, have been and are increasing contributors to value in elements of the global economy; also that the value of constituent companies' assets, are increasingly challenging to assess across the variety of their intangibles' type/nature - going back to the 1980s.

ii Reporting of businesses' intangibles in their various forms has been the subject of research interest, which shows that there are different perceptions from different perspectives. Amongst other things, the results showed overall there to be discernible differences between users and preparers of company reports in their opinions expressed on the need/want for more detailed information on intangibles; the users seeking increased clarity and detail, in contrast to the latter suggesting that information is sufficient, with its collection and reporting being too costly and time consuming, as well as complicated and already adequately detailed. However, needs of investors and general stakeholders, as users of reports, should take priority – with due consideration to companies' (technological) competitive confidentiality.
iii This lack of sufficiently detailed and specific intangibles information in the public domain may have contributed to increasing Mergers & Acquisition activities targeting technology-based companies. Many continue to be subjects of successive acquisition activity, such as ARM in the UK from 2016 where the stock market-based value rose by ~50%, over about 6 months from the start of acquisition interest till the purchase by SoftBank for ~£24billion in summer 2016, and is still the subject of continuing M&A attention, now at a valuation in the region of US$40billion. More recently many UK tech-based companies are being targeted, resulting in their share prices rising significantly in a relatively short period. M&A activity in the technology sectors is also increasing in the USA, where intangibles are also difficult to assess, never mind value; the challenge of the IASB's principles-based separation of research from development does not exist in the rules-based system in the USA's reporting of conflated 'R&D'.

iv Confirmation could be inferred from this widespread interest and activity that, amongst other things, the values of companies' IA, both perceived and actual, were, and still are, not easy for investors, especially retail/private, to estimate/calculate from the accounts and other information published in companies' report and accounts.

v There is a trend in many technology-based companies to conflate 'R&D' expenditure in reporting research and development (as in the USA) – which seems to go against/ignore the principles of separation promoted in the *requirements* of the Standard. A contribution to this conflation trend, and the perceived initial under-valuations apparent from rapid share price increases in face of M&A activity, may be the lack of clarity in the Standard in distinguishing Research expenditure (to be expensed) and Development expenditure (to be capitalised).

vi In keeping with the intended principles of the Standard, entries of 'R&D' should only exist in companies' published financial statements if both *may* be expensed, but should be individually separate as expensed Research and capitalised Development; the company's own distinction between the two being described/defined in their own Management Commentary – a current project - thus, effectively applying the Standard, reducing the scope for managerial judgement and potential obfuscation, whilst maintaining the principles based approach of IASB Standards in the light of facts and circumstance prevailing.

vii The Standard may be both too restrictive and too flexible as interpreted by companies when expenditure on internally generated intangible assets *can or may* be expensed (noting the difference!), but also insufficiently clear as to when expenditures *should* be recognised as assets.

viii A result in many cases being that expenditure on the actual development phase, which should be capitalised, is inappropriately expensed. This development phase follows the higher risk (expensed) research phase which generates new knowledge and identifies the viability of a product, potentially suitable for the subsequent lengthy

and expensive development phase - test-bed, animal/human trials, etc, - in advanced technology, engineering, science, pharma, etc. companies.

ix As consequences of expensing development costs, along with research, there are a number of potential outcomes which might be 'useful' to a company management's judgement in certain circumstances, some of which may sometimes constitute financial engineering and/or obfuscation for example:

- keeping profit, and hence tax, lower;
- keeping reported assets' value lower along with markets' perceptions of company assets' value, which in turn lowers the share price, so that the directors who may have been granted shares as part of their remuneration, possibly amongst other insiders, gain as the share price increases significantly over a short time when a company comes under the attention of a potential acquirer, etc. This may, or possibly may not be, in the best interests of many other shareholders or general stakeholders.

Also, there may consequently be increased need for loans (at currently low interest rates) and/or share issues to strengthen the balance sheet – which could/should have been achieved through increased investment in product innovation and capitalising development expenditures in the first place.

x A different (type of) reason for companies to avoid capitalising development expenditure may include the perceived risk (to reputation, *inter alia*) of eventual project failure before (or after) entering the market and achieving customer acceptance – leading to impairment of the related asset. However, this negative perception of impairment may be the result of investors' and markets' prejudice, which should/need not exist; if the development costs are eventually impaired due to product failure in development or the market, resulting in the assets' values initially recorded in the balance sheet at development resulting in excessive value, then the eventual impairment has the same long-term result as expensing the development expenditure in the first place – as is customary at present. The consideration of impairment in this context could possibly be included in the current Goodwill and Impairment project. There is a need here for management, and their preparers of reports, to remember the relationship between risk and reward, to reduce some accountants' and other peoples' inclination to excessive short-term risk sensitivity, and devote more time to focus on profitable longevity.

xi The debate/discussion/decision about recognition of the intangibles' value at cost, market or fair value may not need to exist in many cases, particularly in the case of new product development. There is no point in generating an intangible asset (maybe a product in the form of an artefact or service) and then *always* valuing it at cost; that would suggest there is no economic benefit (profit) expected to flow as a result of the 'new knowledge' gained from research. However, it may be appropriate to expense Research costs because of the associated risks and lower success probability (P), maybe (P) $\leq$ 50%, during research; but, once the potential product *that has the potential to produce economic benefits* has been identified, so then enters Development (eg test-bed or trials), expenditure at the minimum (or present) value should be capitalised because probability, (P) > 50%, of economic benefit flowing to the company is recognised – as suggested in the Conceptual Framework. After certification and/or successful trials' acceptance and 'launching' the product into the market, value should be expressed as an asset at present/fair/market value; because if it is not expected to generate profit after Development and launch then it is being effectively regarded as a failure and expenditure should be expensed at cost or impaired if already capitalised (because it would later probably be classed as failed development cost and thus impaired anyway).

xii Part of this may be the outcome of perceived insufficient clarity on what constitutes an asset and/or its ownership, legal rights, and value. Companies are increasingly reluctant to disclose IP and/or apply for patents – especially in relatively small companies – because of the associated necessary disclosure, risk of 'theft', and the financial resources required to defend legal rights and/or a patent in court in the face of increasing IP/patent trolling; protection often being achieved through internal company secrecy, and/or speed to market achieved through small company agility - in contrast to larger companies, and countries, where recording numbers of patents is a type of pride and PR exercise to impress others. This may lead to the possible need to review the Conceptual Framework (and/or related Standards), though it was usefully revised recently in this area.

xiii Some internally generated intangible assets held for sale can be results of in-house research in the form of 'spin-off' or bi-products which the company will not use or develop internally, but which are held for sale to companies that could/would use them as sources of income. These 'intangibles' are definitely assets as potential sources of income, but may not be classified as Intangible Assets.

(b) Should the Board add any financial reporting issues not described in Appendix B to its work plan for 2022 to 2026?

Make Standards consistent, accessible and generally easier to understand, interpret and apply their principles through stakeholder outreach engagement to a broader audience outside the accounting profession; this would better identify and understand the wants and needs of report users – not least of intangibles as mentioned in the retiring Chairman's introduction.
The issues that I consider important, in the projects described Appendix B, are included above.

Question 4

Do you have any other comments on the Board's activities and work plan?
An integrated approach across all Standards under consideration is necessary for consistency.
Apart from that, only those comments covered above.

Bibliography

- FRC Research: Business Reporting of Intangibles: Realistic Proposals, July 2019 intangibles project confirmed the different perceptions from a number of perspectives
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- Financial Times, 3 June 2021, Baruch Lev, *Apparent losers can become biggest winners.*