

# Draft Report: Intangibles Qualitative Research

## Executive Summary

<b>Project Type</b>	Research Project
<b>Project Scope</b>	Significant
<b>Purpose of the paper</b>	
<p>This paper presents a full draft of the main text of the report of the UKEB's Qualitative Research Project on Intangibles (see Appendix A). The draft report incorporates feedback on sections of the report received at previous Board meetings. A preliminary stakeholder engagement strategy for the report is also included.</p>	
<b>Summary of the Issue</b>	
<p>The Project Initiation Plan (PIP) for the research project was approved at the April 2022 UKEB meeting<sup>1</sup>. This phase of the research work is focused on stakeholders' views on the accounting for intangibles, drawing on qualitative research based on in-depth interviews.</p> <p>The first half of the draft report was discussed by the Board at the October 2022 meeting. The second half of the draft report was discussed by the Board at the November 2022 meeting. A complete draft of the main text of the report is attached to this paper (see Appendix A); it includes the text already discussed by the Board and a new executive summary and conclusions. The appendices to the report are still being finalised and will be included for the final report to be discussed at the January 2023 Board meeting.</p> <p>The paper also includes the current stakeholder engagement strategy to disseminate the findings of the published report in 2023.</p>	
<b>Decisions for the Board</b>	
<p>The Board is not asked to make any decisions. Board members are asked if they have any comments on:</p> <ol style="list-style-type: none"><li>1. The draft report and next steps?</li><li>2. The proposed stakeholder engagement strategy?</li></ol>	

<sup>1</sup> Subsequently amended. The latest version of the PIP was approved at the October 2022 Board meeting. ([Updated Project Initiation Plan - Intangibles Project.pdf \(kc-usercontent.com\)](#))

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<b>Recommendation</b>
N/A
<b>Appendices</b>
Appendix A [Draft] Qualitative Research Report: UK Stakeholder Views on Accounting for Intangibles

## Background

1. In one of his first public statements the chair of the IASB, Dr Andreas Barckow, stated that “the rise of self-generated intellectual property and its non-addressal in the accounts” was one of the biggest challenges and opportunities facing the IASB. This reflected growing stakeholder concerns about the accounting for intangibles
2. 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.
3. The IASB staff paper 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.”
4. 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.” To date no specific timeline is provided.
5. 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 to provide investors with more useful general purpose financial statements which would help them make better informed decisions.
6. The initial phase of the research is focused on understanding stakeholders’ 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 draft report is discussed in more detail in the next section of this paper.
  - b) A report detailing 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. It will also include an analysis of whether and how current reporting practices affects economic outcomes.

- c) A report based on more comprehensive investor outreach, further developing the learnings from the qualitative and quantitative research. The primary research will be based on a survey of users, and potentially other outreach (such as interviews, roundtables).
7. This phase of the UKEB research on accounting for intangibles is explorative by design. Its aim is to provide a better understanding of UK stakeholders' perspectives on the accounting for, and reporting of, intangibles in the UK, and the potential economic outcomes arising from the existing accounting framework. The report will form the basis for later research focused on providing a solid evidence base to support any UKEB's recommendations for the IASB.
8. Details of the primary focus of the intangibles research and a breakdown of interviewed stakeholders were discussed at the October 2022 UKEB meeting<sup>2</sup>.
9. The report is comprised of the following sections (see full draft in Appendix A):
- a) Executive summary
  - b) Introduction
    - i. Background
    - ii. The responses to the IASB Third Agenda Consultation
    - iii. The debate about accounting for intangibles in the UK
  - c) Intangibles: economic context
    - i. Intangible capital: features and economic consequences for firms
    - ii. Economic prevalence
    - iii. Economic prevalence of intangible assets
  - d) Stakeholders' Concerns with IAS 38
    - i. "What's wrong" with IAS 38: a literature-informed summary of stakeholders' views
  - e) Stakeholders' suggestions for potential improvements: Opportunities and challenges

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<sup>2</sup> [5.0 Research Project on Intangibles – Draft Report, amended PIP and response to EFRAG .pdf \(kc-usercontent.com\)](#)

- i. Fundamental considerations
  - ii. Enhanced recognition
  - iii. Measurement
  - iv. Enhanced disclosures
  - v. Materiality matters
- f) Conclusions
- g) Report Appendices
- i. Glossary
  - ii. Methodology
  - iii. Breakdown of the participants
  - iv. References
10. A draft of the first half of the report was discussed at the UKEB's October 2022 meeting (see October 2022 Board paper 5 Appendix 1<sup>3</sup>). A draft of the second half of the report was discussed at the UKEB's November 2022 meeting (see November 2022 Board paper 10 Appendix A<sup>4</sup>).

## **Full draft – Qualitative research report: UK stakeholder views on accounting for Intangibles**

11. A complete draft of the main text of the report is attached to this paper (see Appendix A), it includes the text already discussed by the Board and a new executive summary and conclusions. The appendices to the report are still being finalised and final versions will be included for the final report to be discussed at the January 2023 Board meeting.
12. As this is a draft, cross-referencing has not been finalised. It will be included once the text is finalised (indicated with grey highlighting).
13. We would like to highlight some changes in approach in response to the November Board discussion.

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<sup>3</sup> [5.0 Research Project on Intangibles – Draft Report, amended PIP and response to EFRAG .pdf \(kc-usercontent.com\)](#)

<sup>4</sup> [10.0 Research Project on Intangibles – Draft Report](#)

- a) Most stakeholder quotes have been incorporated back into the main text.
- b) We have included clear intros and outros to major themes identified from stakeholder comments.
- c) Three text boxes have been significantly shortened and are now shown in the main body of the report. The text of two proposed boxes related to the UKEB Advisory Groups has been incorporated into the main text of the report.

## Next steps

14. A final draft of the report will be presented to the Board for approval, subject to any final redrafting, at the January 2023 Board meeting.
15. We currently expect to publish the report around the end of January 2023, followed by stakeholder engagement, discussed in the next section.

### Questions for the Board

1. Do Board members have any comments on the draft report included in Appendix A?
2. Do Board members have any comments on the proposed next steps?

## Proposed stakeholder engagement strategy

16. The Secretariat is preparing a plan in collaboration with the Stakeholder Engagement Team on how to engage with external stakeholders to disseminate the report findings and raise awareness about the working on intangibles being undertaken by the UKEB.
17. An important element of the engagement strategy will be engaging with users of financial statements, hearing their views, and encouraging them to participate in the upcoming user survey on accounting for intangibles.
18. At this point in time the following events are planned or under discussion:
  - a) **February 2023 – IAG:** Presentation of findings and discussion on subsequent research.
  - b) **March 2023 – CFA:** Hybrid event proposed for March 2023
  - c) **April 2023**

- i. **Academic Advisory Group:** Presentation of findings and discussion on subsequent research.
  - ii. **IFASS:** Presentation of findings.
  - iii. **ONS:** Event proposed for March/April 2023
19. We are also going to explore the possibility of a presentation or panel event at the following conferences:
  - a) **British Accounting and Finance Association (BAFA) Conference<sup>5</sup>:** April 2023
  - b) **2023 IASB Research Forum<sup>6</sup>:** November 2023
20. The Secretariat is planning to discuss presenting the intangibles research with the following organisations:
  - a) Other international standard setters and standard setting bodies (CFSS)
  - b) User groups (the IA, CRUF etc)
  - c) Preparer groups (QCA, 100 Group etc)
  - d) Professional accounting bodies (ACCA, ICAEW, ICAS etc.)
  - e) Academics
21. The timeline will be regularly updated as events are secured.
22. We will also raise awareness about the report through various UKEB channels, including the UKEB Advisory Groups, the UKEB newsletter, and LinkedIn.

### Questions for the Board

3. Do Board members have any comments on the proposed stakeholder engagement strategy?
4. Are board members aware of other events where we could highlight this work or organisations we should approach? Would any Board members like to present the report findings at an event of their choice or organisations where they may be a member?

<sup>5</sup> [BAFA - BRITISH ACCOUNTING AND FINANCE ASSOCIATION -](#)  
<sup>6</sup> [IFRS - IFRS Foundation announces 2023 IASB Research Forum](#)

# [DRAFT] ACCOUNTING FOR INTANGIBLES

UK Stakeholder Views

January 2023





IFRS Foundation Copyright and disclaimer wording to be inserted here

# Draft for comment

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# Executive Summary

1. This paper summarises UK stakeholders' concerns with the accounting for intangibles under IAS 38 *Intangible Assets*, and their views of potential improvements.
2. IAS 38 specifies accounting for all intangible assets, not addressed by another IFRS Accounting Standards. It "sets out the criteria for recognising and measuring intangible assets and requires disclosures about them"<sup>1</sup>.
3. A large number of the IASB's stakeholders, including the UKEB, responded to the International Accounting Standards Board's (IASB) Third Agenda Consultation (undertaken in 2021) with requests that it undertake a project examining the accounting for intangibles. Following the agenda consultation, the IASB added a research project on intangibles to its future research agenda.
4. This paper is the UKEB's initial contribution to the international discussion on this topic and is aimed at informing both the UKEB's and the IASB's future deliberations. This paper also forms part of the evidence base that the UKEB will be producing over the coming months<sup>2</sup> to ensure that UK stakeholders' views can be taken into consideration from the outset.<sup>3</sup>
5. The evidence collected in this report is based on semi-structured interviews with over 30 UK stakeholders, covering key participants in the production and use of general-purpose financial statements including: preparers from companies of various sizes and industries, different types of users of accounts (analysts, investors, credit rating agencies), auditors, other accounting professionals, individuals who have been part of accounting standard setting, academics, and regulators. The variety of stakeholders interviewed, as well as the number of interviews conducted, ensures that the views reported offer a comprehensive representation of the range of UK stakeholders' opinions on the IFRS accounting for intangible assets.
6. The interviews essentially focused on two primary topics: what do stakeholders believe is wrong with the accounting for intangibles under IAS 38, and what can be done to improve the accounting for intangibles. No single theme emerged on either topic that could be identified as "the one problem" or "the one solution". However, there were a number of common threads, which are summarised below.
7. **What is wrong with IAS 38:** the overwhelming comment from UK stakeholders was that IAS 38 is an "old standard", and specifically that, in its current form, it does not address the needs of the current business and economic environment where intangibles play a pivotal role (see Section 2 Intangibles: economic context). Beyond this, stakeholders expressed the following three concerns:

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1 [IFRS - IAS 38 Intangible Assets](#)

2 [Updated Project Initiation Plan - Intangibles Project.pdf \(kc-usercontent.com\)](#)

3 The views expressed in the report should not be interpreted as the UKEB position on intangible assets but only as a summary of UK stakeholders' views.

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- a) IAS 38 has a high threshold for recognition of intangible assets, which may lead to under-reporting of these items on companies' balance sheets.
  - b) IAS 38 requirements for intangibles leads to inconsistent accounting outcomes for similar assets when compared to other standards such as IFRS 3 *Business Combinations* and IFRS 6 *Exploration for and Evaluation of Mineral Resources*.
  - c) IAS 38 disclosures do not always lead to informative or useful information.

A minority of stakeholders were satisfied with IAS 38 and preferred to maintain the current approach, possibly with some enhancement to disclosures.

8. **How can IAS 38 be improved:** stakeholders made a range of suggestions to improve the accounting for intangibles. The key themes that are summarised below:

- a) **Enhanced recognition:** stakeholders requested exploration of a greater range of internally generated intangible items being recognised and capitalised. In particular, consideration of approaches that might lead of recognising brands, training, the research component of research and development, and, to a lesser extent, Artificial Intelligence algorithms and big data. Including a greater range of intangibles in the balance sheet, they argue, would be relevant to users of financial statements.
- b) **Measurement:** stakeholders expressed mixed views on their preferred model for measurement, particularly under an enhanced recognition approach. Overwhelmingly stakeholders discussed a cost-based model for initial recognition and subsequent measurement of internally generated intangible assets. However, certain stakeholders preferred a fair value model for some items under certain conditions.
- c) **Disclosures:** stakeholders requested more disclosures about intangible items, regardless of whether they were recognised in the balance sheet or expensed directly to profit or loss. Some stakeholders considered enhanced disclosure an important adjunct to enhanced recognition and measurement. Others considered enhanced disclosure on its own as a sufficient improvement to the accounting for intangibles. However, most stakeholders agreed that more granular disclosures about intangible expenses was necessary. Other types of disclosures mentioned included, how intangible items interlinked with company objectives and underlying business model, and risks associated with future cash flows.

9. Other recurrent themes relating to IAS 38 are also discussed in this report, such as the application of materiality to intangible items, accounting for cryptocurrencies, and the relationship between companies' and national accounting.

10. The UKEB looks forward to contributing to future discussions on the accounting for intangibles. Gathering evidence and views from a range of sources and stakeholders will be vital to developing a long term solution to the accounting for what is a difficult accounting matter.

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# I. Introduction

“The biggest challenge I see is to remain relevant in an ever-changing environment. While I think that our literature has generally stood the test of time, there have been changes in the environment that clearly could not have been anticipated when the Standards were developed. I am thinking of economies becoming more service than manufacturing oriented... as well as the rise of self-generated intellectual property and its non-addressal in the accounts”<sup>4</sup>

Chair of the IASB Andreas Barckow

- 1.1 Following the results of the Third Agenda Consultation completed in July 2022, the International Accounting Standards Board (IASB) has announced that it expects to review the accounting requirements for intangibles within the next few years<sup>5</sup>. While the nature and scope of the project are yet to be finalised, the project has been positioned as a “comprehensive review”<sup>6</sup>.
- 1.2 The IASB noted that many stakeholders responding to the Third Agenda Consultation “highlighted deficiencies in the reporting of intangible assets ...relating to all aspects of IAS 38, including its scope, its recognition and measurement requirements ...and the adequacy of [disclosures]”<sup>7</sup>.
- 1.3 The IASB acknowledged that any project on intangibles will likely be large and complex for both the IASB and its stakeholders. They also noted that the project should “aim to address intangibles more broadly”, focusing not just on “assets”, but also including intangible items currently expensed.
- 1.4 In anticipation of an IASB review of intangible items the UK Endorsement Board (UKEB) decided to initiate a research project focussed on understanding UK stakeholders’ views on the accounting for intangibles<sup>8</sup>. The UKEB wanted to understand the concerns with the current approach to the accounting for, and reporting on, intangibles, particularly under IAS 38 *Intangible Assets*, as well as possible ways in which these could be improved<sup>9</sup>. To obtain a better understanding of the landscape, this report considers both the economics of intangible items alongside the accounting treatment.
- 1.5 The report takes a qualitative approach, drawing from over thirty one-to-one interviews conducted with a diverse range of stakeholders. The approach provided an opportunity to understand different perspectives from stakeholders across the accounting landscape.

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<sup>4</sup> [IFRS - Meet the new IASB Chair—Andreas Barckow](#)

<sup>5</sup> [Feedback Statement: Third Agenda Consultation \(ifrs.org\)](#)

<sup>6</sup> [IFRS - IASB pipeline projects](#)

<sup>7</sup> [Feedback Statement: Third Agenda Consultation \(ifrs.org\)](#) (pg. 27)

<sup>8</sup> The UKEB began developing and researching a project in late 2021 in anticipation of a project examining intangibles being an outcome of the Third Agenda Consultation.

<sup>9</sup> For simplicity the rest of the report uses the term “accounting for intangibles” to mean both accounting on and reporting of intangibles.

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The views heard are contrasted with findings from relevant reports and academic papers, in particular contributions focusing on the UK.

- 1.6 This report draws out some common themes that point to specific attributes stakeholders are looking for in any solution aimed at addressing the accounting for intangibles. The report also provides useful background to inform further research by the UKEB on the topic, with the purpose of supporting its engagement with the IASB's own project on intangibles.

## Background

### Intangibles under International Accounting Standards – IAS 38

#### Scope

- 1.7 IAS 38 *Intangible Assets* specifies accounting for all intangible assets that are not in the scope of another IFRS Accounting Standard. In particular, the following are explicitly identified as outside the scope of IAS 38:
- a) Financial Assets (IASs 32 and 39, IFRSs 7 and 9)
  - b) Certain assets arising from the exploration and evaluation of mineral resources (IFRS 6)
  - c) Intangible items held for sale in the ordinary course of business (IAS 2)
  - d) Deferred tax assets (IAS 12)
  - e) Lease of intangible assets (IFRS 16)
  - f) Goodwill acquired in a business combination (IFRS 3)
  - g) Insurance contracts (IFRS 17)
  - h) Assets arising from contracts with customers (IFRS 15)
- 1.8 IAS 38 (para 8) defines an intangible asset as “an identifiable non-monetary assets without physical substance”.
- a) “Identifiable” means the asset is either separable (IAS 38, para 12a), that is it can split from the other assets of the company and control passed to another entity, or “arises from contractual or other rights”.
  - b) “Non-monetary” excludes monetary items (IAS 38 para 8) which are “money held and assets to be received in fixed or determinable amounts of money” (presumably primarily financial instruments).
  - c) “Without physical substance” is undefined, but presumably can be contrasted items with physical substance, such as the purchase, or development of, property, plant, equipment, inventory, agricultural items etc.
- 1.9 IAS 38 (para. 9) provides the following examples of items that could be consider as intangibles “computer software, patents, copyrights, motion picture films, customer lists,

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mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights.”

- 1.10 These criteria were not revised following the revision of the definition of an asset in the *Conceptual Framework for Financial Reporting (Conceptual Framework)* issued in 2018.

## Recognition

- 1.11 IAS 38 (para 10) goes on to state that to be recognised as an intangible “asset” the following criteria (which were part of the old Conceptual Framework definition of an asset) must also be met:
- a) the item is controlled by the entity (IAS 38, para 13),
  - b) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity (IAS 38, para 21)<sup>10</sup>.
- 1.12 In addition to these general requirements for of recognition, IAS 38 explicitly prohibits the recognition of “internally generated brands, mastheads, publishing titles, customer lists and similar items” as intangible assets (IAS 38, para 63). The reason given is that the cost of generating an intangible asset internally is often difficult to distinguish from the cost of maintaining or enhancing the entity’s operations or goodwill.
- 1.13 Goodwill acquired in a business combination is recognised and measured in accordance with IFRS 3 *Business Combinations* (para. 32) and is outside the scope of IAS 38 (para. 3). Internally generated goodwill is within the scope of IAS 38 but is explicitly excluded from recognition as an asset (IAS 38, para 48) because “it is not an identifiable resource... controlled by the entity that can be measured reliably at cost” (IAS 38, para 49).
- 1.14 Any other internally generated intangibles are classified as to whether they arise in a research or development phase. According to the Standard, research expenditure must be recognised as an expense. Development expenditure that meets specified criteria can be recognised as an intangible asset at cost.
- 1.15 These recognition criteria are widely considered as particularly restrictive in the academic literature and industry practice<sup>11</sup>. This high bar has historically led to relatively few internally generated intangible assets being recognised in financial statements (see paragraphs XX-XX).
- 1.16 It should be noted that IFRS 3 *Business Combinations* requires the recognition of all identifiable intangibles in a business acquisition and explicitly acknowledges that this “may result in recognising some assets... that the acquiree had not previously recognised...[including] brand name, a patent or a customer relationship, that the acquiree

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<sup>10</sup> See later discussion on the meaning of these terms (paragraphs XX-XX).

<sup>11</sup> These views are noted by the European Financial Reporting Advisory Group (EFRAG) that “due to the age of IAS 38 there are concerns about adequacy when identifying, recognising and measuring internally generated assets... [such that] that a fundamental overhaul of the Standard was necessary” (EFRAG, 2019, p. 1–2). Similarly, Davies et al. (1999, p. 916) commented that the recognition criteria are “rather tortuously worded”. For instance, the inherent uncertainty of future economic benefits, coupled with an inability to reliably measure such benefits, raises difficulties in separating out the identifiable development costs” (Mazzi, et al. 2022, pg. 8). This shows the difficulties with recognition and measurement of intangibles in the financial statements due to the stringent requirements set by the IAS 38.

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did not recognise as assets in its financial statements because it developed them internally” (IFRS 3 para 13).

- 1.17 Much of the language in IFRS 3 is consistent with IAS 38, both talk about the intangible needing to be identifiable, and while IFRS 3 does not explicitly require control it is implicit in the asset definition. The core difference seems to be that probability is a recognition principle in IAS 38, while in IFRS 3 it forms part of measurement<sup>12</sup>.

## Measurement

- 1.18 Intangible assets that meet the recognition criteria are usually measured at cost (IAS 38, para 24). If an intangible is acquired through a business combination then its fair value is deemed to be its cost (IAS 38, para 33).
- 1.19 After initial recognition, an entity usually measures an intangible asset at cost less accumulated amortisation (IAS 38, para 74). It may choose to measure the asset at fair value when fair value can be determined by reference to an active market, though this is expected to be “uncommon” (IAS 38, para 78).<sup>13</sup> If the recognition of intangible assets happens in a business combination, they are measured at fair value on the acquisition date (IFRS 3, para 18).
- 1.20 At initial recognition, an entity must also assess whether an intangible asset has a finite or indefinite life. Some intangibles that may be considered to have indefinite lives include brands and licenses granted in perpetuity. An intangible asset with a finite useful life is amortised and is subject to impairment testing. An intangible asset with an indefinite useful life is not amortised but is tested annually for impairment.

## Disclosure

- 1.21 IAS 38, at paragraph 118, includes a number of disclosure requirements, including for each class of intangible assets:
- a) distinction between internally generated and other intangible assets;
  - b) information on useful lives;
  - c) additions, indicating separately assets arising from internal development, assets acquired separately, and assets acquired through business combinations.

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<sup>12</sup> With reference to intangible assets, these two recognition thresholds have historically led the balance sheets of companies that grow organically to look different from the ones of companies that grow by acquisition, making the comparison between entities challenging, and leading investors to use non-financial statements information to make capital allocation decisions. As a consequence, there is agreement among both academics and practitioners that “comparability is adversely affected as intangible assets acquired outside a business combination are only recognised if it is probable that the expected future economic benefits, attributable to the asset, will flow to the entity and the cost of the asset can be measured reliably. For intangible assets acquired in a business combination these criteria are always considered to be met”. In contrast to this, some users think it is not worthwhile to compare internally generated assets with those acquired given its different nature of risk and reward profiles (CRUF, 2022, [Download \(efrag.org\)](#)).

<sup>13</sup> It must be noted though that some examples have recently arisen of intangible assets that are commonly traded on active markets, such as cryptocurrencies. Cryptocurrency holdings are currently classified as intangibles based on an IFRIC Agenda decision in June 2019 (see [Box 2](#)). At the time of writing, however, the prevalence among UK companies (and in particular companies applying IFRS) is understood to be limited.



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## Terminology: intangibles assets, intangible expenditure, intangible items or intangible capital?

“In a legal, economic or business-related circumstance, there are many different terms that follow [the] intangible concept: intangibles, intangible assets, intangible values, intellectual capital, intellectual property, knowledge assets, invisible assets. They either characterize a particular area of intangibles or are used interchangeably to designate the intangible vision, in general.”<sup>14</sup>

- 1.22 To understand stakeholder concerns with the current accounting for intangible items and their views on how to improve it necessitates defining what is meant by “intangibles”.
- 1.23 These items are in general outside the scope of this report, unless otherwise noted.
- 1.24 In this report we generally use the term “Intangible Assets”, to refer to intangible items specifically recognised in IAS 38, or when quoting stakeholders’ responses verbatim. This is because the term “asset” has a general meaning under the *Conceptual Framework for Financial Reporting*, while the term “intangible asset” has a specific, and potentially different meaning under IAS 38 as is discussed later in this report<sup>15</sup>.
- 1.25 We will generally use the term “intangible item” or “intangible expenditure” depending on the context when considering the accounting aspects of recognising, measuring and disclosing information relevant to intangibles. In the economic sections we will use instead the expression “intangible capital”, more common in this literature<sup>16</sup>
- 1.26 IAS 38 also distinguishes between “internally generated” and “purchased” intangibles, with a distinction also captured by academic research<sup>17</sup>. We will discuss this distinction further in paragraphs XX-XX.

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<sup>14</sup> Nichita, Elena-Mirela, Intangible Assets – Insights From a Literature Review (June 1, 2019). Accounting and Management Information Systems, Vol. 18, No. 2, pp. 224-261, 2019

<sup>15</sup> Many of the concerns raised about the accounting for intangible items relates directly to whether or not they should be accounted for as assets.

<sup>16</sup> The IASB has also started to use similar terminology (i.e. intangible items) for similar reasons. In the IASB’s April 2022 paper suggesting they undertake an intangibles project they acknowledge that “although this paper refers to a project on intangible assets... one key issue to consider in such a project is whether it should be limited to accounting for and disclosing information about financial statement elements—intangible assets and expenses arising from expenditure on intangible items—or whether the project should aim to address intangible items more broadly” (para 36).

<sup>17</sup> See for example Zambon et al. (2020) “A literature review on the reporting of intangibles”.

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## The responses to the IASB Third Agenda Consultations

- 1.27 Calls for the IASB to address intangibles became much more explicit in response to the Third Agenda Consultation, undertaken in 2021.<sup>18, 19, 20</sup>
- 1.28 For the third agenda consultation, the IASB received 124 comment letters<sup>21</sup>. The focus of respondents' concerns was:
- a) The current intangible assets standard (IAS 38) needs comprehensive review by the IASB as it was published in the 1990s with a focus on manufacturing businesses with primarily tangible assets. The recent shift towards service-oriented businesses is not accommodated properly by the standard;
  - b) Due to the limitation in requirements in IAS 38, accounting for new emerging assets (e.g., emission trading rights, cloud-based computing arrangements and crypto-currencies) and transactions remains challenging;
  - c) Some respondents believe the IASB should revisit the reasons for the differences in the recognition criteria for internally generated intangibles and those acquired separately;
  - d) Many respondents supported the requirement to improve the disclosures of intangibles not recognised as assets;
  - e) A few respondents asked the IASB to consider the potential overlap of sustainability with the intangible items as these are key drivers of sustainable business development and sustainability reporting.

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<sup>18</sup> In February 2010, following the second Constitution Review, the IFRS Foundation introduced the requirement for a three-yearly public consultation on the IASB's technical agenda, known as an Agenda Consultation. The Agenda Consultation provides a channel to seek public input on the IASB's broad strategic direction, as well as the balance and shape of the IASB's work plan. To date three Agenda Consultations have been undertaken by the IASB. Importantly, intangibles have featured in all of them.

<sup>19</sup> The first Agenda Consultation was undertaken in 2011. The IASB received 245 comment letters. 54 respondents (22%) referenced intangibles, with 19 (8%) stating that a project on intangibles should be a high priority. Respondents' concerns were mixed with respect to the contents. The IASB noted that "respondents believe that it is a relevant topic because of the increasing importance of intangible assets in the world market and that an update is due, because IAS 38 is out of date" (IASB, 2012, para 60). Following the first Agenda Consultation a project on Intangible Assets was added to the IASB's Research Programme, however it remained inactive: [AP8: Research Programme update—2015 Agenda Consultation \(ifrs.org\)](#)

<sup>20</sup> The second Agenda Consultation was undertaken in 2015. The IASB received 119 comment letters. A review of the comment letters indicates that approximately 40 (33%) of respondents referred to intangibles, though there were mixed views on the level of commitment to be given to a project on intangibles. In the IASB's comment letter analysis the only substantive mention of intangibles within the context of the Conceptual Framework. Respondents expressed little appetite for undertaking new standard setting projects. However the UK's Financial Reporting Council (FRC) letter to the IASB noted that "A project to revise IAS 38 Intangible Assets should be added to the work plan so that consideration can be given as to whether to amend it to reflect the revised definition of an asset." Nonetheless, no project focusing on intangibles originated from the second agenda consultation: see [IASB Work Plan 2017-2021 Feedback Statement 2015 Agenda Consultation \(ifrs.org\)](#)

<sup>21</sup> 81 respondents (65%) referenced intangible items, with 20 (16%) stating that a project on intangible items was a high priority. <https://www.ifrs.org/projects/completed-projects/2022/2020-agenda-consultation/request-for-information-and-comment-letters/#view-the-comment-letters>

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- 1.29 The UKEB comment letter<sup>22</sup> recommended a comprehensive review of IAS 38. Noting that any IASB review should address:
- a) The extent to which IAS 38 captures relevant information on intangibles, including those which are becoming more prevalent, such as cryptocurrencies, pollutant pricing mechanisms, software, and development costs, and;
  - b) Whether separate standards addressing non-financial assets would provide more relevant information where intangibles such as crypto-currencies and emissions trading rights are held for investment.
- 1.30 Other respondents argued that revisiting the recognition and measurement criteria of intangibles could improve comparability, prevent loss of useful information, and better reflect the importance of intangibles.
- 1.31 Also respondents noted that entities' value creation in the modern era relies significantly on intangible items. Human capital may be the most critical source in the modern knowledge-based economy (see paragraphs XX-XX), but other important intangible items include big data, brands, efficient business processes and customer relationships. Disaggregation of such information about an entity's value creation activities would be helpful for users as it provides insight into an entity's ability to generate future profits and cash flows.
- 1.32 In April 2022 the IASB confirmed the addition of a research project on intangible items to its work plan<sup>23</sup>.

## The debate about accounting for intangibles in the UK

- 1.33 In the UK, debates about the accounting for intangibles and calls for an improved accounting standards for intangibles are not new.
- 1.34 For example in the early 1990s there was

"no shortage of suggestions on how the information flow on R&D between industry and the City (London's financial community) can be improved. For example, valuable recommendations have been made (on the measurement, accounting treatment and disclosure of R&D) in reports by the House of Lords Select Committee on Science and Technology (1991), the Institutional Shareholders' Committee (1992), the Accounting

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<sup>22</sup> [Final Comment Letter - Agenda Consultation.pdf \(kc-usercontent.com\)](#)

<sup>23</sup> The IASB staff paper 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." The IASB staff suggested that because a comprehensive review of IAS 38 would be both complex and time-consuming it may be better to take a staged approach. They suggested some potential approaches but acknowledged that this would be better considered as part of project planning later on.

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Practices Group of the Chartered Institute of Management Accountants (1992) and the International Accounting Standards Committee (1993)." <sup>24</sup>

- 1.35 The Financial Reporting Council (FRC), in its role as national standard setter, has undertaken two major projects on Intangible Assets.

## **FRC ARP Staff Research Report: Investor Views on Intangible Assets and their Amortisation (March 2014) <sup>25</sup>**

- 1.36 In 2014, the FRC undertook a research project: 'Investor Views on Intangible Assets and their Amortisation' to understand the investors' views on intangible assets and whether the reporting requirements in IAS 38 provided useful and reliable information. Overall, investors had mixed views. The paper highlighted several concerns with the accounting for intangibles, especially when acquired in business combinations. The main findings were:
- a) Half of the respondents wanted different accounting treatment to those required by IAS 38;
  - b) Some investors distinguished intangible assets into two types: 'wasting intangible assets' (i.e. with a finite useful life) and 'organically replaced intangible assets' (i.e. with no indefinite useful life) and suggested amortisation of wasting intangible asset and an impairment only model for organically replaced intangible assets;
  - c) Others suggested an impairment review rather than periodic amortisation for all intangible assets acquired in business combination;
  - d) With regard to internally generated intangible assets:
    - i. most respondents agreed with capitalising development costs for internally generated assets in line with IAS 38;
    - ii. a few suggested capitalising research costs whilst others suggested to expense all R&D, even at development stage. The most common reason given was the quality of disclosures and lack of consistent application for capitalisation of assets;
    - iii. More respondents generally favoured the periodic amortisation of these assets generated internally than those acquired in business combination..
  - e) In contrast many investors expressed views that the separately acquired intangible assets should be capitalised and amortised annually.
- 1.37 Ultimately, most investors were dissatisfied with the quality of disclosures, especially as the information about the objective of business combinations and the purpose of intangible assets acquired was not always provided, and then used to perform post-acquisition reviews.

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<sup>24</sup> Nixon (1997) The Accounting Treatment of research and Development Expenditure - View of UK Company Accountants, page 267.

<sup>25</sup> [ResearchProjectonIntangibleAssetsMarch2014.pdf \(frc.org.uk\)](#)

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## Business Reporting of Intangibles: Realistic proposals

### A Discussion Paper prepared by staff of the UK Financial Reporting Council (February 2019)<sup>26</sup>

- 1.38 The FRC issued the paper 'Business Reporting of Intangibles: Realistic proposals' was published in 2019 to add to the international debate and gather stakeholders' views to influence the IASB. The objective of this paper was to explore reasons why intangibles are not fully reflected in financial statements and to develop practical proposals to improve business reporting.
- 1.39 The report concluded that the definition of assets and recognition criteria in the Conceptual Framework restricted the recognition of many intangibles. Given the revision of the Conceptual framework during 2018, the paper considered that the reporting of intangibles could be enhanced within the new framework, especially the information about the value of internally generated intangibles. It also considered the possibility of addressing the reporting of intangibles outside of the financial statements e.g. in narrative reporting.
- 1.40 Disclosures about expenditure on intangibles were highlighted as an important area of improvement. The report noted that there was poor disclosure about 'future oriented intangibles' which are expensed in current period with a view to drive benefit in subsequent accounting periods. Better disclosure would go some way to address the issue of earnings management as there is a time lag between incurring expenditure on intangibles and return received from it in future.
- 1.41 In addition to the above, narrative reporting in management commentary section of an annual report was identified as another way to enable provision of information on unrecognised intangibles, focusing on those intangibles that are relevant to entity's business model, requiring common metrics and agreed definitions and calculations to promote comparability of information on intangibles over several periods and within the same industry.

## Introduction - in summary

- 1.42 Concerns about the accounting for intangible items are not new. Recognition, measurement and disclosure all were identified as areas of concern. This has led, both internationally and in the UK, to calls for a different approach.
- 1.43 At the heart of these concerns is that the accounting does not reflect the economics when it comes to Intangible items. This is a key concern. The Conceptual Framework of Accounting posits that "Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the substance of the phenomena that it purports to represent." (para 2.12, emphasis added).

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<sup>26</sup> [00 Intangibles-title 1..2 \(frc.org.uk\)](#)

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- 1.44 Similar concerns arose during stakeholders' interviews. The results are discussed in a subsequent section of this report (paragraphs XX-XX).
- 1.45 The next section examines the economics of intangible items that provides a framework to better understand both the current accounting practices, the concerns stakeholders have about them, and any potential solutions proposed – in other papers and by our interviewees.

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## 2. Intangibles: economic context

- 2.1 This section considers intangibles (in economics often referred to as “intangible capital”) from an economic perspective.<sup>27</sup> Specifically, it focuses on the ‘missing’ intangibles from national accounts and contribution to growth at a national level (macroeconomics), a review of the literature on the positive correlation between intangibles and companies’ performance and KPIs (microeconomics), and their effect on companies’ returns and price informativeness (financial economics).<sup>28</sup>
- 2.2 Economic information is aimed at helping contextualise the current accounting treatment of intangibles, the problems associated with the accounting, and solutions proposed by other literature and stakeholders. The rationale is to demonstrate that intangibles are a key driver of productivity and growth, from both a micro- and macroeconomic perspective.
- 2.3 To the extent that accounting aims to reflect companies’ underlying economics, based on the economics literature, an argument can be made that they should be more broadly recognised on companies’ financial statements.
- 2.4 To support this argument, this section considers the prevalence of intangible capital in the UK economy, focusing on both national and individual companies’ accounts.
- 2.5 The report uses the evidence provided to show that while intangible assets have grown in importance over the last 15 years, their prevalence is likely understated due to the current individual and national accounting rules.

### **Intangible capital: features and economic consequences for firms**

- 2.6 Intangibles have always been a key driver of innovation of products, processes, productivity, and economic growth. However, in the contemporary UK economy, commonly labelled as the “knowledge economy”, intangible capital plays a bigger and more pervasive role than ever before.<sup>29</sup>
- 2.7 The expression “knowledge economy”, was introduced by Drucker (1969), but the real rise of the knowledge economy occurred with the emergence of the “service economy”, i.e., an economy skewed towards services and its reduced reliance on manufacturing.<sup>30</sup> The transition to the knowledge economy was underpinned by the fast spread of information

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<sup>27</sup> In this section we refer to “intangible capital” to distinguish how the concept is used in the economics literature from its specific use in the international accounting context (see paragraph 12). To avoid repetition, we may also use the term “intangibles” within this section.

<sup>28</sup> The issues herein described, in turn, have fed into the design of our interview questions, and helped instruct discussions with interviewees that went beyond mere technical accounting considerations.

<sup>29</sup> Powell and Snellman, 2004.

<sup>30</sup> A phenomenon in turn labelled post-industrialism or post-Fordism, see Bell, 1976.

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and communication technology (ICT)<sup>31</sup>. Drucker's knowledge economy is characterised by:

- a) Greater importance of knowledge-based service sectors;
- b) A higher proportion of skilled to unskilled workers;
- c) A greater relevance of research-steered innovation;
- d) Importantly, a higher reliance on intangible capital for value creation.

2.8 This concept has been developed by Powell and Snellman (2004) who define the knowledge economy as: "production ... based on knowledge-intensive activities that contribute to an accelerated pace of technological and scientific advance as well as equally rapid obsolescence. The key components of a knowledge economy include a greater reliance on intellectual capabilities than on physical inputs or natural resources, combined with efforts to integrate improvements in every stage of the production process, from the R&D lab to the factory floor to the interface with customers. **These changes are reflected in the increasing relative share of the gross domestic product that is attributable to intangible capital**" (emphasis added).

2.9 The economics literature has long recognised the contribution of intangible capital to the economy broadly, and companies specifically. It is broadly understood as "skills, organizational structures and processes, culture, and other factors"<sup>32</sup>, that enhance firms' productivity and growth, as well as influence their stock prices.

2.10 However, because of its inherent characteristics, economists have shied away from providing more prescriptive definitions for intangible capital, besides recognising that to be called "assets" or "capital" they should be a resource the economic benefits of which are reaped over the long-term.<sup>33</sup>

2.11 From an economic perspective, intangible and tangible capital share some common features: they both have a durable impact on the companies' performance and their returns are reaped over future periods of time. In addition, the value of both tangible and intangible capital generally depletes over time<sup>34</sup>.

2.12 Based on these characteristics, economists have identified features that distinguish intangible from tangible capital, the most common and relevant of which are<sup>35</sup>:

- a) **Invisible:** intangible capital lacks physical substance and needs a storage medium<sup>36</sup>;

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<sup>31</sup> Hope and Martelly, 2019, and references therein.

<sup>32</sup> Brynjolfsson, Hitt and Young, 2002 (emphasis added).

<sup>33</sup> See Thum-Thysen, Voigt, Bilbao-Osorio, Maier and Ognyanova (2017).

<sup>34</sup> Both defining features of assets: see Thum-Thysen et al., 2019; Crouzet, Eberly, Eisfeldt and Papanikolaou, 2022. We note that in some instances, international accounting rules allow the recognition of intangible assets with indefinite useful life, for example brands (when acquired in a business combination, as per IFRS 3).

<sup>35</sup> The below list is distilled from Crouzet, Eberly, Eisfeldt and Papanikolaou, 2022; Haskel and Westlake (2017); Andrews and de Serres (2012); Villalonga (2004).

<sup>36</sup> See the pioneering theoretical framework of Crouzet et al. (2022) in particular, where the need for a storage medium is emphasised as one of the two defining characteristics of intangibles alongside with being non-rivalrous.



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- b) **Tacit:** intangible capital may be implicit knowledge embedded in people;
  - c) **Non-rivalrous:** intangible capital can be used simultaneously by multiple users without depleting the asset or reducing its usefulness;
  - d) **Partially excludable:** property rights over intangible capital cannot always be easily defined or enforced;
  - e) **Non-tradable or traded in imperfect markets:** intangibles are often internally generated and while things are changing, they are still often non-fungible and therefore non-tradeable. When they are traded, they are typically traded in imperfect markets;
  - f) **Non-separable:** intangible capital often cannot be separated from the business where it is created without loss of value; and
  - g) **Complementary:** intangible capital often adds value in conjunction with other types of capital, either tangible or intangible, and labour.

2.13 These features have important economic consequences commonly found across companies, industries and economies that invest more in intangible capital:

- a) **Higher productivity:** because of their complementarity with other capital and the synergies they create within the organisation, intangible capital is found to enhance productivity<sup>37</sup>;
- b) **Spillover effects (externalities)**<sup>38</sup>: intangible capital is found to have sizable positive spillover effects, and positively to contribute to productivity, salaries, training and enhance skills and human capital well-beyond the boundaries of the firms that invest in them<sup>39</sup>;
- c) **Network externalities:** because of their non-rivalrous and invisible nature, intangible capital is often a main contributor to network effects, which arise when “the value of a good or service increases for both new and existing users as more customers use it; the more existing users there are on a network, the more attractive it becomes for newcomers”<sup>40</sup>;
- d) **Sunk costs:** because investment in intangibles is neither separable from the firm, nor tradeable it is often non-recoverable<sup>41</sup>;

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<sup>37</sup> Brynjolfsson, Hitt and Young (2002); Hall (1993); Griliches (1981); Lev and Sougiannis (1996); Bresnahan, Brynjolfsson, and Hitt (2002).

<sup>38</sup> Spillovers or externalities are situations in which the activities of one agent in the market induce external effects (either positive or negative) on other agents in that market.

<sup>39</sup> See Department of Business, Innovation and Skills (2012), and in particular Tables 16 and 20; see Goodridge, Haskel and Wallis (2017).

<sup>40</sup> Quote from [Morningstar](#) (2017); see also [Intermede](#) (2020).

<sup>41</sup> See Hölzl (2005) and literature therein.

- e) **Risks and uncertainty:** intangible capital is difficult to liquidate, which makes assessing its recoverable value more complicated and leading to companies that invest in intangibles possibly riskier<sup>42</sup>; and
- f) **Lack of measurability:** intangible assets are also notoriously difficult to measure, which makes companies' valuation by equity investors trickier<sup>43</sup>.

2.14 These characteristics and their economic consequences make the identification and measurement of intangible assets tricky – something that has driven the accounting for intangibles prescribed by IAS 38.

## Intangible assets in macroeconomics

2.15 The contribution of intangible investment to macroeconomic growth, and the issues of recognising and measuring intangible investment in national accounts, from which they are largely absent, are all heavily researched. As discussed further in this section (paragraphs XX-XX and Box 1), there is a relation between national accounts/statistics and companies' accounts, as national accounts/statistics on intangible assets are estimated by surveying companies. This creates comparable difficulties when preparing accounts and filling-in national surveys.

2.16 In its simplest form, the output of a closed economy (that is ignoring international trade) can be described as the sum of three items:

- a) consumption by households
- b) investment in productive goods
- c) government expenditure

2.17 In their seminal contributions, Corrado, Hulten and Sichel (2005 and 2006; (the CHS framework)) noted that intangible capital had historically not been considered as an input of production in economic models, where only labour and physical capital were typically introduced. This led to intangible capital being neglected both as investment of productive goods and output itself in national accounts. As a consequence, investment in intangible capital was not accounted for at a national level, with large swathes of GDP and related economic growth being consequently neglected in most economies<sup>44</sup>.

2.18 Since its publication, the CHS framework has influenced both national and international accounting systems, so that research and development is considered a component of investment in many national accounts<sup>45</sup>. Unfortunately, many other intangible items (such as brand, training or design) are still not widely accounted for at a national level (see Martin, 2019), though some statistics offices (including the UK ONS) calculate

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<sup>42</sup> Thum-Thysen et al. (2017). Andrews and de Serres (2012).

<sup>43</sup> See Martin and Baybutt (2021), Martin (2019) and Box XX.

<sup>44</sup> See also Nakamura (2003a, 2003b, 2010).

<sup>45</sup> For example the UN System of National Accounts (SNA) and the European System of Accounts (ESA).

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experimental statistics for intangible investment not officially accounted for (see paragraphs XX-XX) <sup>46</sup>.

- 2.19 According to the CHS framework, intangible items can be bucketed into three categories<sup>47</sup>:
- a) **Computerised information:** mainly computer software;
  - b) **Innovative property:** broadly corresponding to research and development; and
  - c) **Economic competencies:** comprising brand equity, training and human capital, and organisational capital.
- 2.20 With reference to the UK, Goodridge, Haskel and Wallis (2014) apply the CHS framework to estimate UK intangible investment at a national level and its contribution to economic growth. While the paper's results are now dated (the most recent set of results displayed in the paper dates back to 2009), the importance of their findings is unaltered. The paper found that, as of 2009, national intangible investment had surpassed tangible investment, and was amounting £124 billion (tangible investment was £94 billion) <sup>48</sup>. Of these, 70% were internally generated investments. Organisation capital was the largest category, accounting for 21% of the investment, followed by software (18%), design (12%) and R&D (11%).
- 2.21 Importantly, the authors also estimate that intangible investment positively contributed to national productivity in the UK. According to the authors, during the period 2000-2009 intangible assets accounted for 26% of the growth in value added per hour worked. The joint contribution of intangible capital and tangible investment in ICT (computer and telecommunication) accounted for 45% of the growth in value added per hour worked.
- 2.22 In separate contributions, these authors have estimated whether unmeasured intangible assets can help explain the UK productivity puzzle, that is an observed slowdown in both labour productivity (output per hour) and total factor productivity observed after the financial crisis (see [The Economist, 2022](#)). In a recent paper (Goodridge and Haskel, 2022) the authors estimate that in 2019 the difference between what productivity was and what it would have been following the pre-crisis trend was 28 percentage points, of which roughly 5% could be explained by unaccounted intangible assets. These results confirm previous estimations (Goodridge, Haskel and Wallis, 2013), which suggests that, using the authors' own words, "unmeasured intangibles are part of the explanation of the productivity puzzle, but not all of it". For example, Goodridge, Haskel and Wallis (2016)

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<sup>46</sup> This literature is relevant to our report for two reasons: firstly, the issues faced by national accountants and statistician when dealing with the recognition and measurement of intangible investment and assets are (unsurprisingly) very similar to the ones faced by standard setters and companies' accountants. Secondly, correctly recognising and measuring intangible assets at a company level is important to help measure national output and therefore contribution of private investment to the long-term public good.

<sup>47</sup> See Corrado, Hulten and Sichel (2006), Pages 16 and following and Table 1.

<sup>48</sup> For more recent estimates by the ONS see paragraphs XX-XX.

estimate that 35% of the puzzle could be attributed by slow total factor productivity growth in the oil and gas and financial sector industries.<sup>49,50</sup>

- 2.23 As emerged from interviews with stakeholders, there is a relation between companies' financial statements and national accounts/statistics in relation to the measurement of intangibles, as national statistics are estimated based on surveys of individual companies, who face comparable difficulties when preparing accounts and filling-in national surveys. This has two main consequences:
- a) the difficulties in recognising and measuring intangibles are largely shared by the two types of accounting;
  - b) lack of recognition of intangible assets at a company level can translate into under-reporting of intangibles at a national level, simply because of companies' level data is unavailable to start with.
- 2.24 These issues are explored in greater detail in Box 1 below (see also paragraph 88).

**Box 1: Why is accounting for intangibles so difficult? A comparison between national and company accounting**

- B1 As noted in paragraphs XX-XX, intangibles are key drivers of the knowledge economy. Despite their importance, a relatively limited number of intangibles are currently recognised on both companies' and national accounts. While the two accounting systems have different purposes and follow different frameworks, interviews with stakeholders and papers on the topic suggest that the practical challenges faced when accounting for intangible assets are similar for both.
- B2 In particular, national accounts and statistics on intangibles are typically estimated based on surveys of individual companies. The fact that intangibles are not recognised at company level is likely to also makes it trickier to estimate them for the purposes of responding to national statistics surveys. This lack of recognition in the company accounts is thus potentially affecting the quality of national statistics/accounts.
- B3 Research suggests that companies face difficulties similar to the ones raised by stakeholders about IAS 38. Specifically:
- a) **Capitalising vs expensing** – As internally generated intangibles are produced in the course of business, it is not always easy for companies that respond to ONS surveys to separately identify the portion of intangibles related to the

<sup>49</sup> Other UK-focused contributions extend the CHS framework to account for additional types of intangible capital. For example, Corrado, O'Mahoney and Samek (2021) develop a model to incorporate formal education/schooling into the national production function, thus treating national spending in education as an investment rather than as consumption (as it's currently accounted for). O'Mahoney and Samek (2021) develop a framework to incorporate health into human capital stocks at a national level. The authors show that, on average, poor health reduces human capital stock by 12% in the United Kingdom.

<sup>50</sup> Outside of the United Kingdom, Corrado, Haskel, Ionni, Jona-Lasinio, Mas and O'Mahoney (2017) apply the CHS framework to EU countries, finding that in the EU14 over the 2000-2013 period the share of intangibles over GDP was lower than that of tangibles: 7.2% against 9.4%. The authors however found that northern and non-German speaking continental countries were characterised by higher investment in intangible capital than Mediterranean and German-speaking continental countries. Elnasri and Fox (2017) apply the CHS framework to Australia, showing that in 2015 intangible investment was ASD 82 billion, well-below the ASD 227 billion invested in tangible capital. This suggests that, as expected, reliance on intangible capital tends to differ between countries.

current period and that related to the future, and so to be capitalised. This often leads to underreporting and inconsistent survey responses for intangible investments in surveys submitted to the ONS (Martin and Baybutt, 2021).

- b) **Ability to identify intangibles as stand-alone items** – Interviews suggested that companies often struggle to identify intangibles as stand-alone items, resulting in management not measuring, recording, or reporting their value for the purposes of their responses to ONS surveys. This is particularly true for new intangibles such as databases of personal information, where it is tricky to even identify what the asset is or to assign a value to it.
- c) **Control over the expected economic benefits** – Interviews with stakeholders suggested that respondents to ONS surveys tend to have a more complete picture of the intangibles they hold and their value when they exert ownership over intangibles. Ownership is not understood as *legal* ownership necessarily, but rather as *economic* ownership: that is the ability to reap future economic benefits from an asset when possessed but not owned (e.g. a lease). Yet, failure to demonstrate ownership often leads to the inability to report information about intangibles, which often leads to underreporting.

B4 Given that the challenges faced are similar, it is possible that improved accounting for intangibles at a company level may translate into better national reporting for intangibles, a desirable outcome from a long-term public good perspective.

## Intangible assets in microeconomics

2.25 The microeconomics literature has extensively studied the relationship between investment in intangible capital and firm-level outcomes, generally finding a positive relation between intangible capital and firms' performance<sup>51</sup>. These results suggest that enhanced information about intangible capital would be important to evaluate a firm's perspective of generating profits in the long run, thus arguably leading to a more efficient capital allocation.

2.26 Many contributions focus their attention on the relationship between intangible capital and firm productivity. With reference to the UK, Riley and Robinson (2011) estimate the impact of the three types of intangible capital identified in the CHS framework on firm-level output and find that they are positively associated with firms' output. The paper emphasises sectorial differences, with intangible capital linked to higher productivity more in the services than in the manufacturing sectors.

2.27 A paper by Marrocu, Paci and Pontis (2011) estimates the relationship between intangible capital and production (measured as value added) at a country level using firm-level and regional data from six European countries, including the UK.<sup>52</sup> The paper finds a positive correlation between intangible capital and value added considering all countries together. This relation is even stronger than the average when the model is estimated for the United Kingdom only, consistently with the UK being a knowledge-based economy (see paragraphs 2.20-2.21).

<sup>51</sup> Firm-level capital market outcomes are discussed separately in the following section.

<sup>52</sup> The paper differentiates between intangible capital, measured at a firm level, and human, social, technological and public capita, measured at a regional level. We refer to the paper itself for more detailed definitions of these capitals.

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- 2.28 More recent contributions focusing on other countries also establish a positive relation between intangible capital and productivity. See footnote for further details.<sup>53</sup>
- 2.29 Other firm-level outcomes have been discussed in the literature. Using UK firm-level data Nemlioglu and Mallick (2017) find that companies that are R&D intensive and have more organisational capital (as hinted in their paper by good managerial and innovative practices) tend to perform better in terms of profitability. They caveat however that during economic downturns companies skewed towards intangible capital may have worse valuations than in normal times as intangible assets are more difficult to liquidate.
- 2.30 Focusing on other countries, Villalonga (2004) finds that intangible capital allows positively affects companies' competitive advantage in the United States; Montresor and Vezzani (2016) using EU data shows a positive relation between intangible capital and productivity; Di Cintio, Ghosh and Grassi (2017) find that intangible capital is associated with more exports and economic growth in Italy<sup>54</sup>.

## Intangible assets and capital markets outcomes

- 2.31 Research has shown that firms that invest more in intangible assets are associated with better stock price performance and other positive market outcomes, consistently with the

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<sup>53</sup> Roth, Sen and Rammer (2021), focusing on Germany, find a positive relationship between intangible capital and firm-level productivity, which stronger magnitudes for services firms (as opposed to manufacturing). Crass and Peters (2014) also focus on Germany. Following the framework introduced in Corrado et al. (2005), their paper differentiates intangible capital into Innovative capital (IC), Branding capital (BC), Human capital (HC) and Organisational capital (OC). The authors find that the R&D component of IC to be strongly and positively related to firms' total factor productivity, as well as all components of BC (marketing, trademarks) and HC (training, high skilled labour). The authors find mixed results with respect to OC. Bontempi and Mairesse (2015) study the contribution of intangible capital to production, using Italian firm-level data. They find that intangible capital positively and strongly contributes to output, and the result is robust to the estimation of different production functions. They break down intangible capital into Intellectual capital (IK) and Customer capital (CK), and find that the marginal productivity of CK is higher than that of IK. Takizawa (2015) studies the effect of intangibles play in labour productivity growth in the US and Japan. They find that intangibles are positively related to labour productivity growth in the US, but not in Japan, though investment in both tangible and intangible assets was found to have a positive relation with labour productivity growth in both countries. Hsiao, Lo, Lin and Lin (2021) study the determinants of intangible investment in Taiwan, as well as the relation between intangibles and productivity.

<sup>54</sup> More in detail: Villalonga (2004) discusses how intangible assets can affect long-term competitive advantage, measured as profits persistence. Using US listed companies' data, the author finds that intangible capital are a determinant of a firm's long term profitability and henceforth the source of competitive advantage in most industries. However their results show that intangible assets can also "lock in" competitive disadvantage. Montresor and Vezzani (2014) study the impact of intangible assets on innovation at a firm level. Using pan-European firm-level data for the year 2013, the authors find that internally generated intangibles explain firm-level innovation more than externally generated intangibles. In addition, "technological intangibles" (whether internally generated or not) also have a significant influence on companies' ability to innovate. Di Cintio, Ghosh and Grassi (2017) look at the relation between investment in R&D, firms' export and firms' growth using a sample of Italian SMEs. Using a convincing empirical strategy, the authors show that R&D is associated with both more exports and more growth, though firms that export tend to grow less as a result of R&D. The authors did not find any direct effect of exports on companies' growth.

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fact that intangible assets are associated with higher profitability and better firms' performance.<sup>55,56</sup>

- 2.32 One reason to look at the financial economics literature is that the accounting for intangible assets can directly affect broadly used financial indicators such as market-to-book ratios. One empirical regularity in financial economics traditionally explained by the lack of recognition of intangible assets is the market-to-book value puzzle (Lev, 2001), i.e. evidence, largely based on US data, that the market-to-book ratio for value stocks has been disproportionately high for XX years. Lev (2001) suggests that unrecognised intangible assets can largely explain the phenomenon. Hulten and Hao (2008) attempt to solve the puzzle by adjusting book values for intangible. The authors find that excluded intangible assets explain between 40-50% of market value of R&D intensive firms, suggesting that they contribute to explain the puzzle but are only part of the story.
- 2.33 Some recent contributions explore the relation between intangibles and stock prices. Bongaerts, Kang and Van Dijk (2022) find that companies with higher shares of intangible assets outperform companies that invest less in intangibles, generating an economically significant average return of 4.6% per annum. The results hold when excluding big tech firms (Amazon, Apple, Facebook, Google, Microsoft, Netflix and Tesla)<sup>57</sup>. Eisfeldt, Kim and Papanikolaou (2022) note that the tendency of stocks characterised by high market-to-book ratios ("value" stocks) to outperform stocks characterised by low market-to-book ratios ("growth" stocks) has weakened over the last ten years and attribute this evidence to intangible assets being largely absent from book values.<sup>58</sup>
- 2.34 Financial statement information about intangible assets has also been demonstrated to convey relevant information that is impounded in stock prices. For example, Oswald, Simpson and Zarowin (2020) exploit the transition from UK GAAP to IFRS in 2004/2005 to estimate whether the capitalisation of R&D expenses, mandatory under IFRS, impounds information into stock prices. Using the transition as a natural experiment, they find that capitalisation of R&D information adds relevant information to stock prices. Importantly, they find that pre-IFRS adoption the market could not infer what portion of R&D expenses constituted investment, suggesting that explicit requirements to capitalise intangibles convey relevant information to users of financial statements.

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<sup>55</sup> These are discussed in a separate section as the economic theory, the empirical techniques and the data utilised to estimate the empirical models are substantially different from the ones used in microeconomics.

<sup>56</sup> Extra care was taken to ensure that the academic studies cited in this section provide evidence based on "normal" market conditions (i.e. based on trading periods characterised by no exceptional market-wide events) and that the evidence reported is robust across academic studies and therefore broadly generalisable. However, it should be noted that the evidence provided in studies that use market data may be applicable to that specific market or dependent on market conditions.

<sup>57</sup> The authors extend a traditional Fama and French 5-factor asset pricing model (Fama and French, 2015) to include an "intangible intensity" factor capturing the share own-generated intangible assets over total assets. Their factor excludes goodwill. For their estimations, the authors use returns on the Russell 3000 constituents for the 1989-2020 period.

<sup>58</sup> Focusing on the econometrics, the authors create an intangibles-adjusted HML factor (which captures the performance of value stocks) that outperforms the traditional Fama and French (2015) HML factor by 2.11% annually. Park (2022) conducts a similar exercise and obtains comparable results.

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## New intangibles

- 2.35 Both academics and industry practitioners have identified several new intangible asset classes which have risen to prominence largely as a result of development by US and Chinese tech-firms.<sup>59</sup> These intangibles, which could be broadly categorised as “digital assets”, are by and large related to the spread of artificial intelligence (AI) algorithms used by tech companies for different purposes, such as to commercialise their products, enhance user experience, or improve their own decision making.
- 2.36 **Digital capital.** A 2020 paper focusing on the US showed that listed firms have become more digital capital-intensive over the last 20 years. The stock of digital capital is disproportionately bigger in firms in the largest decile of market capitalisation, which includes “superstar” tech firms. The authors estimate that digital capital positively contributes to firms’ productivity.<sup>60</sup>
- 2.37 **Big data.** Thanks to recent technological advancements, and especially developments in AI technology, (some) companies are now able to collect, store and analyse large amounts of data (including personal data) on an unprecedented scale (hence the name “big data”, popularised by the computer scientist John Mashey in the 1990s). This data is used both for commercial purposes and to enhance internal decision-making processes<sup>61</sup>. Because of big data’s increasing importance as a driver of productivity and source of competitive advantage, some contributions have discussed whether personal data can effectively be considered as a stand-alone asset class, and if so, how to measure it.
- 2.38 A 2021 paper analyses US tech firms’ governance practices to infer what constitutes an asset in relation to the economic exploitation of personal data. They conclude that it’s not ownership (personal data can’t be owned) or access right to the data per se to constitute an asset, but rather the interaction between access rights and technology used to convert that very same data into user metrics to track, record and measure user engagement on their platforms.<sup>62</sup>
- 2.39 A 2022 paper<sup>63</sup> analyses the issues of classification, recognition and measurement of big data from an accounting perspective. Although data is usually stored in servers or USB, the authors establish that it is without a physical substance, it is separable and identifiable and therefore meets the requirements of IAS 38 of intangible asset (including controllability, and generation of future economic benefits). The authors assess alternative methods for recognition and measurement: at cost, using net present value and at fair value. The cost approach appears to be the most prudent in their opinion.

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<sup>59</sup> See Autor, Dorn, Katz, Patterson and Van Reenen, 2020; Tambe, Hitt, Rock and Brynjolfsson, 2020.

<sup>60</sup> Tambe, Hitt, Rock and Brynjolfsson (2020) estimate prevalence and impact on productivity of “digital capital”, understood as “factors of production that are complementary to recorded investments in IT assets (such as hardware and software), but that are not otherwise recorded on a firm’s balance sheet”. The authors estimate the prevalence of digital capital among US publicly listed companies, showing that this has increased dramatically over the last 20 years, largely because of an actual accumulation of capital (the authors estimate that the price of digital capital has roughly remained constant after the dot-com bubble, so growth can’t be attributed to prices).

<sup>61</sup> There is vast literature showing that Big Data Analytics (BDA) is a driver of competitive advantage (see Corte-Real, Oliveira, Ruivo, 2016, and references therein; see Wamba et al., 2017) and innovation (Ghasemaghei and Calic, 2020).

<sup>62</sup> Birch, Cochrane and Ward (2021).

<sup>63</sup> Xiong, Xie, Zhao, Lin and Fan (2022).



However, they deem the fair value approach potentially suitable if there are enough of data from users and collectors to measure the fair value of data assets, such as the data users accessing for example from data trading centres.

- 2.40 **Artificial intelligence:** Corrado, Haskel and Jola-Lasinio (2021) suggest that investment in artificial intelligence (AI) can help explain the market-to-book ratio puzzle (see paragraph 76) as well as the productivity puzzle (see paragraph 66), as currently unrecorded investment in intangible assets is not accounted for as output thus depressing productivity measures. The authors provide evidence that investment in AI has increased dramatically over the last 20 years. The authors suggest that because AI encompasses different aspects of a company's investment strategy, some AI investment may already be captured by national accounts and statistics, for example in software development; they however believe that part of AI investment is still unmeasured. Empirical analyses suggest that taking AI investment into account would not explain the productivity puzzle.

## Crypto-assets

- 2.41 **Crypto-assets.** According to the UK government, crypto-assets are “a cryptographically secured digital representation of value or contractual rights that uses a form of distributed ledger technology (DLT) and can be transferred, stored, or traded electronically”. DLT technology is associated with a variety of products, the most prevalent of which are cryptocurrencies. From an economic perspective, at the time of writing most<sup>64</sup> crypto-assets are generally used as financial than intangible assets, as also emphasised by calls from financial regulators worldwide (including the SEC in the United States and the BoE and the FCA in the UK) to regulate this market. Box 2 discusses economic prevalence, accounting treatment and stakeholders' views of crypto-currencies (the most prevalent crypto-asset) in greater detail.

### Box 2 – Cryptocurrencies: prevalence, accounting treatment and stakeholders' views

- B5 Crypto assets refer to a wide range of digital assets, including cryptocurrency, tokens, stablecoins and non-fungible tokens. **Cryptocurrencies**, the native fungible assets originating from specific distributed ledger technology (DLT) (e.g., Bitcoin, Ethereum), were the most prevalent crypto assets at the time of writing.
- B6 Cryptocurrencies are notoriously volatile.<sup>65</sup> The market capitalisation of cryptocurrencies reached a peak of nearly USD 3 trillion towards the end of 2021, following a hike during the Covid-19 pandemic. Subsequently, the value of cryptocurrencies decreased, stabilising at around USD 1 trillion between May and November 2022. Following the filing for bankruptcy of FTX, a cryptocurrency exchange, the value of cryptocurrencies further declined. As of 23 November 2022, assets under management invested in cryptocurrencies were just above of USD 805 billion, as reported

<sup>64</sup> “Most” is herein understood in terms of money invested. We recognise the existence of crypto-assets such as utility tokens or non-fungible tokens that are not used as financial assets, though at the time of writing their prevalence was much lower than the one of crypto-assets used as financial assets. We are conscious that this may change in the future, and non-financial crypto-assets may become more prevalent in the future, and are therefore monitoring developments in this space.

<sup>65</sup> Because of the inherent risks associated with cryptocurrencies, there have been arguments in favour of regulating this market in the academic literature (see the work of Joseph Lee on the topic, such as [Lee, 2022](#), [Lee, 2020](#), [Lee, 2018](#)) as well as recent advances in this direction, for example in the [United States](#).

by Coinmarketcap.com, a website<sup>66</sup>. Of these, roughly 35-40% were attributable to Bitcoin, the largest by value, followed by Ethereum (15-20%), Tether (7-10%) and other currencies.

- B7 The IASB has maintained a monitoring brief over the accounting for cryptocurrencies. As a result, IFRIC issued a [final agenda decision](#) in June 2019 mandating that cryptocurrency holdings should be classified as Intangible Assets (IAS 38) or Inventories (IAS 2) if held for sale in the ordinary course of business. Some academic research however considered that accounting for cryptocurrencies as intangibles does not reflect the underlying economics.<sup>67</sup> In March 2021, the IASB included the accounting for cryptocurrency among the potential topics of the [Third Agenda Consultation](#). Most stakeholders, including the UKEB, rated both cryptocurrencies and intangible assets as potential projects with a [high priority](#).
- B8 Stakeholders interviewed in general did not raise issues regarding the classification of cryptocurrencies as intangible assets. They raised concerns, however, about measurement, suggesting that an accounting model similar to the IFRS 9 one would be more appropriate for cryptocurrencies. The recent swings in valuation of cryptocurrency may indicate a case-study of the significant measurement uncertainty attached.
- B9 A preparer noted that accounting requirements for crypto-assets as intangible assets forces companies with crypto-asset holdings to create accounts that do not reflect the underlying economics. They did not question the “intangible” classification as such but suggested that crypto assets should be classified based on their intended use, with recognition and measurement at fair value: “Classification should focus on the usage [business model]. The intangible item could be being used for financing, investing or operating activities. This then should also relate to the measurement model. But fair value is a good way to avoid impairment issues.”
- B10 Classification and measurement issues are faced by national accountants too. From interviews it emerged that cryptocurrencies could not be considered akin to financial assets because of the lack of an underlying contract. In addition, the high volatility of cryptocurrencies could cause problems in smaller emerging economies that host active cryptocurrencies markets as the market ups and downs faced by these assets would have a disproportionately large effect on such economies, thus putting a fair value model into question.

## Main lessons from the economics literature

- 2.42 Intangible capital is a key defining feature of the knowledge economy, something that underpins companies’ competitive advantage and defines business models and organisational structures. Yet, intangible capital is inherently difficult to identify. Individual intangible assets are tricky to separate from each other; often they are not traded in organised markets, which makes it difficult to attach a price tag to them. These features make the accounting for intangible assets a challenging job.

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<sup>66</sup> Inaccuracies of the trading data on individual cryptocurrencies from this website have been reported, though cross-checks with other sources performed by the UKEB secretariat confirm that the overall market movements reported on the website are reliable.

<sup>67</sup> Barth (2022), Sixt and Himmer (2019), Prochazka (2018), Tan and Low (2015). See also AASB (2016)

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- 2.43 Because accounting for intangibles is complicated, there has been resistance to add them to national accounts, something that has led to under-reporting at a macroeconomic level. The economics literature has however found that intangible assets do make important contributions to individual economies, and proposed ways to account for these assets at a national level. At a microeconomic level, research has shown that intangible assets are an important determinant of firms' profitability, productivity and competitive advantage. This is in turn reflected on stock price performance, and informativeness.
- 2.44 Taken together, these findings suggest that better accounting for intangibles at a company level is desirable from both a microeconomic and macroeconomic perspective. From a microeconomic point of view, more and better information on intangibles would be relevant to assess companies' economic performance, thus facilitating a more efficient allocation of capital by users of accounts. At a macroeconomic level better accounting at a company level can instead feed into better measurement of investment, and therefore GDP, at a national level. This is a desirable outcome from a long-term public good perspective.

## Economic prevalence

- 2.45 We next turn to assessing the economic prevalence of intangible capital in the UK economy (using national data) and among UK companies (using individual companies' data). The purpose is to understand:
- whether intangible assets have grown in importance over the last 15 years; and
  - the extent to which intangible assets are missing from both national accounts and companies' balance sheets.

## Intangibles in national accounts and economic statistics

- 2.46 As noted in paragraphs XX-XX, intangible assets have traditionally been absent from national accounts, in the UK and internationally. However, based on the CSH framework (see paragraph XX), and thanks to the work of a group of UK academics as well as ONS economists and statisticians<sup>68</sup>, R&D was first introduced into UK national accounts in 2014.
- 2.47 The Bean review<sup>69</sup>, a 2016 independent review of UK economic statistics, emphasised the importance of intangible assets for the UK economy, and the need for a more comprehensive measurement of intangible assets in UK national accounts. While a large portion of intangible investments is not yet included in official UK national account statistics, the Office for National Statistics (ONS) calculates and publishes estimates of

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<sup>68</sup> We would like to mention the work of Jonathan Haskel, Peter Goodridge, Gavin Wallis, Mary O'Mahoney, Josh Martin, Richard Heys, among others, as of particular relevance for the recognition of intangibles in national accounts.

<sup>69</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/507081/2904936\\_Bean\\_Review\\_Web\\_Accessible.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/507081/2904936_Bean_Review_Web_Accessible.pdf)

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investment in intangibles at a national level for the market sector (the so called “experimental statistics”).<sup>70,71</sup>

- 2.48 National and experimental data on intangible assets are calculated by surveying representative samples of UK companies, as well as using administrative data such as VAT forms and PAYE records.<sup>72</sup> National surveys are large and complex to respond to, therefore responses typically involve several staff members, including accountants. For national statistics purposes large companies are broken into different reporting units based on the nature of their business (say, the retail, petrol and insurance divisions of TESCO may be surveyed separately) and geography. This would not happen however for smaller businesses: therefore, in most instances the company in and of itself is the reporting unit.
- 2.49 For our purposes, the existence of these data is important for two main reasons:
- a) They provide an estimate of the prevalence of intangible assets in the UK and can therefore be used to infer the extent to which these are absent from companies’ balance sheets.
  - b) As emerged in relevant literature and in interviews on the topic with the ONS and an academic, because national data is calculated based on surveys of private companies:
    - i. The challenges faced by national statisticians in measuring intangible assets are in many instances similar to the ones faced by individual companies (see Box 1); and
    - ii. Wider recognition of intangible assets at a company level may lead to more comprehensive and consistent statistics at the national level<sup>73</sup>.
- 2.50 Consequently, we believe there are lessons to be learned by looking at the prevalence of intangible assets as per national statistics, as well as by comparing and contrasting how national and companies accounts are calculated.
- 2.51 Figure 1 below displays the trend in tangible and intangible investment for the 1997-2019 period according to ONS experimental statistics.

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<sup>70</sup> See most recent ONS bulletin:

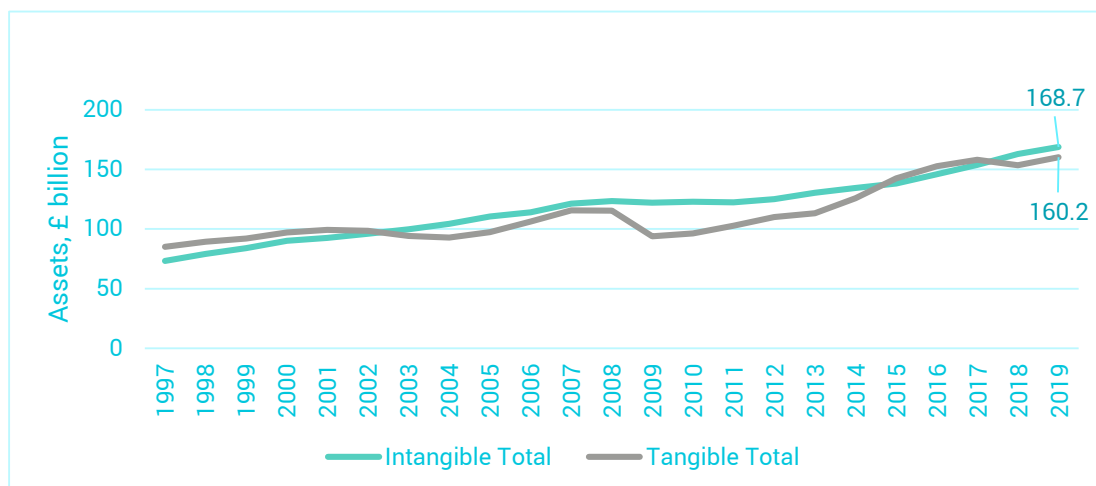
<https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/articles/experimental-estimatesofinvestmentinintangibleassetsintheuk2015/2018#measuring-the-data>

<sup>71</sup> The market sector is defined by the ONS as “the part of the economy that charges economically meaningful prices for its output, and as such operates for profit. Includes all profit-making corporations, whether privately or publicly funded, and excludes non-profit institutions serving households (such as charities) and general government”. See <https://www.ons.gov.uk/economy/economicoutputandproductivity/publicservicesproductivity/methodologies/howtocompareandinterpretproductivitymeasures>

<sup>72</sup> See link to the Annual Business Survey questions, through which R&D data is estimated: <https://www.ons.gov.uk/surveys/informationforbusinesses/businesssurveys/latestquestionsfortheannualbusinesssurveyabsrespondents>

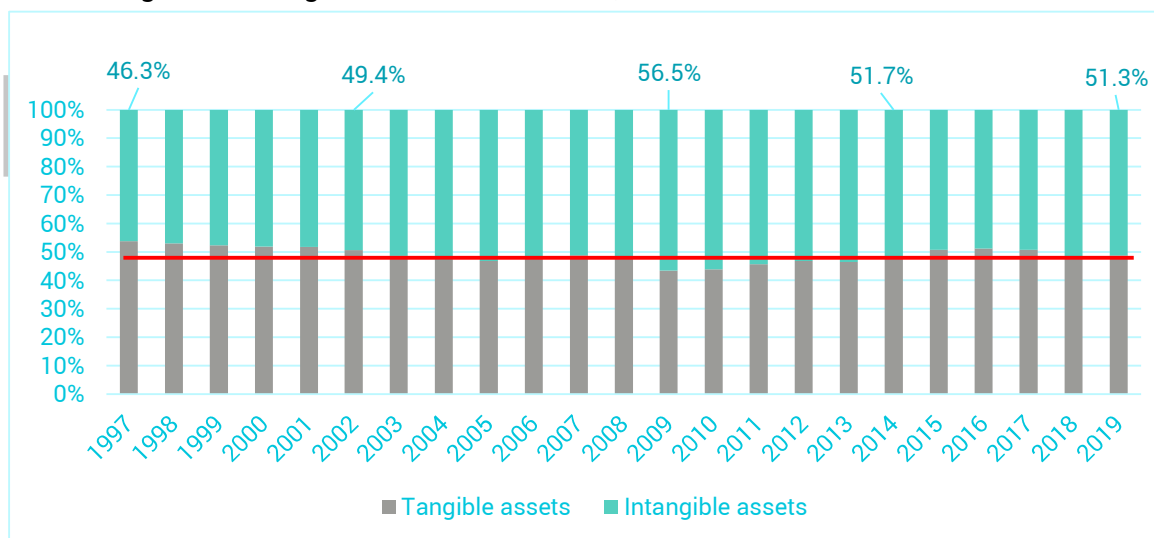
<sup>73</sup> This would be a desirable outcome from the long-term public good perspective.

Figure 1: Trend in tangible and intangible assets investment 1997-2019



2.52 As noted in Martin (2019) and other publications, annual investment in intangible assets is estimated to be roughly equal to investment in tangible assets<sup>74</sup>, a largely “unaccounted half” (see Figure 2) amounting to roughly 7.5% of the country GDP.<sup>75</sup> As of 2019, intangibles investment was nearly £170 billion. Figure 3 provides a breakdown of 2019 investment among different assets (both accounted and unaccounted for).

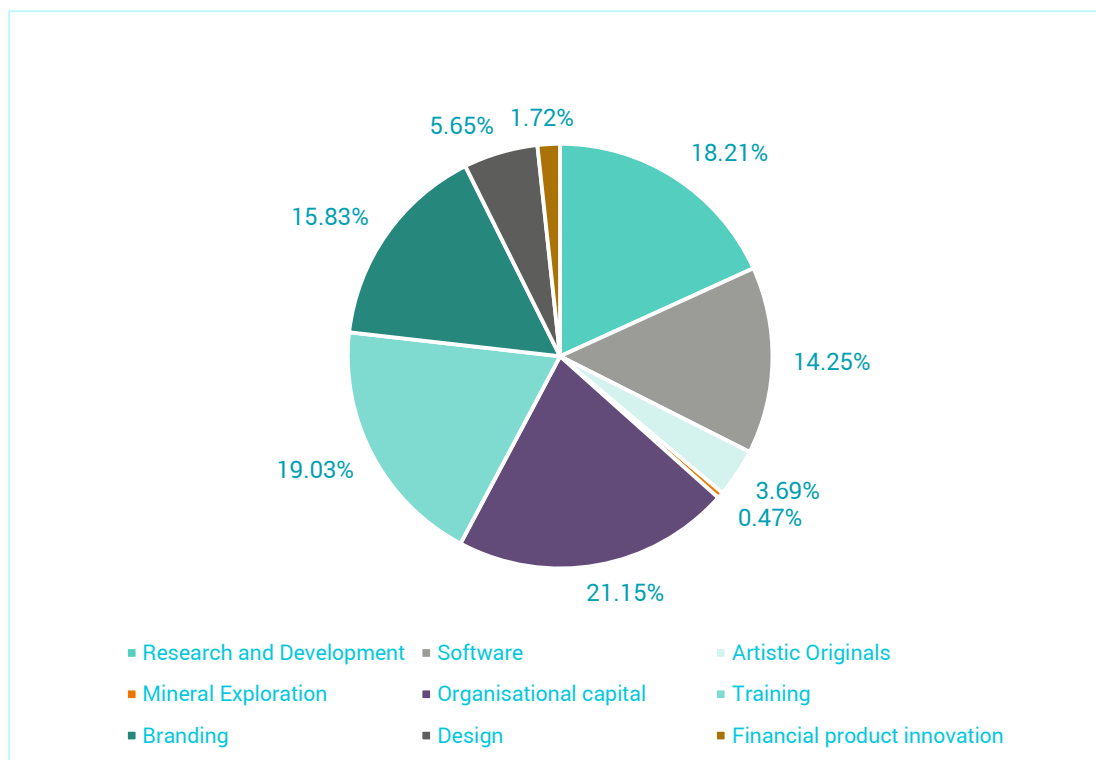
2.53 Figure 2: Intangible assets investment, share of total national investment



<sup>74</sup> See also Roth, Sen and Rammer (2021) who find a similar result using German firm-level data; Peters and Taylor (2017) who estimate the stock of intangible capital to be nearly half of total capital for US firms.

<sup>75</sup> As of 2019, roughly £60 billion were accounted for, of which half could be attributed to R&D, suggesting that total accounted investment (tangible and intangible) was in the ballpark of £230 billion, which is consistent with national account estimates.

2.54 Figure 3: 2019 intangible assets investment, by asset class



Source: UKEB calculations on ONS, Investment in intangible assets in the UK by industry: 2019. Assets accounted for in national statistics: research and development, software, artistic originals, mineral exploration.

## Financial statements information

### FTSE 350 companies

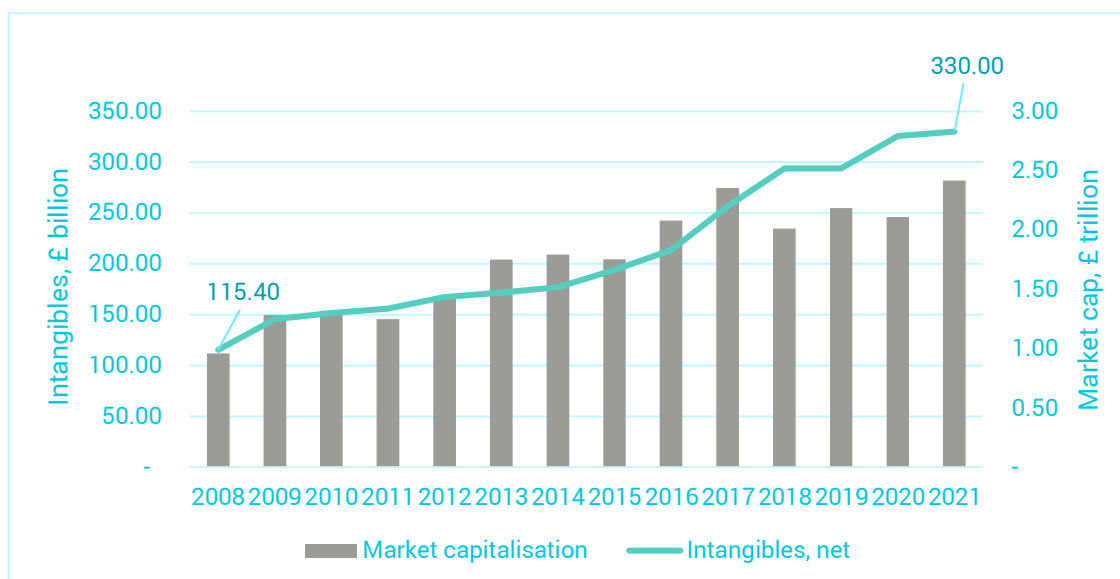
2.55 We calculated the prevalence of intangible assets among FTSE 350 companies using Reuters-Eikon data.

2.56 We firstly look at the trend in the amount of intangible assets included on companies' balance sheets for the period 2008-2021<sup>76</sup>. Figure 4 shows the trend in intangible assets against market capitalisation. We compare these two indicators as several academic studies<sup>77</sup> suggest that intangible assets are a driver to stock prices/market value:

<sup>76</sup> This period was chosen as pre-2008 data was patchier.

<sup>77</sup> Lev, 2001; Hulton and Rao, 2008.

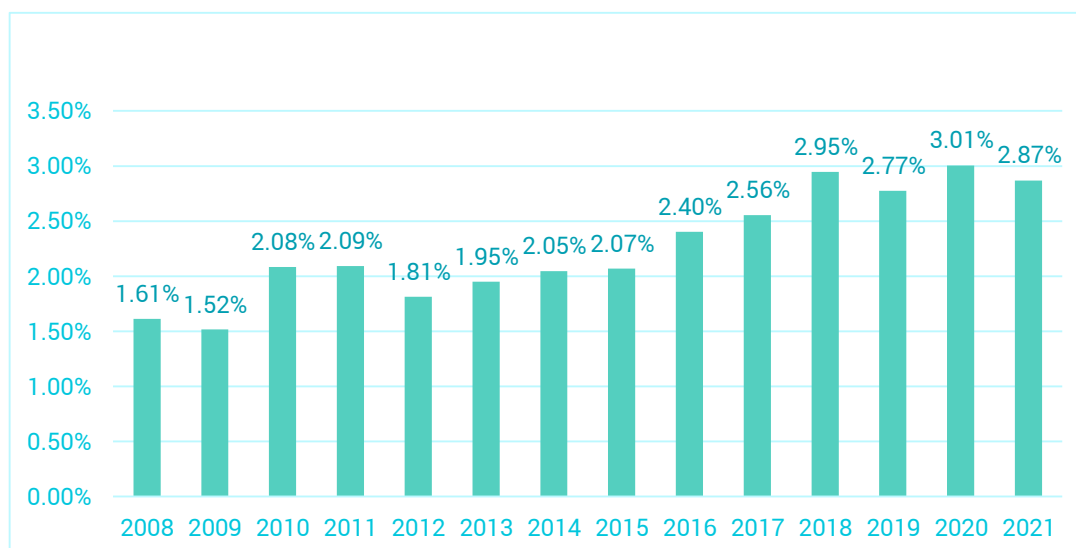
Figure 4: trend in intangible assets, FTSE 350 companies



2.57 As evident from the graph, over the period 2008-2021<sup>78</sup>, intangible assets of FTSE 350 companies show a growing trend, amounting to roughly £330 billion as of 2021 year-end. Between 2008 and 2021 intangibles nearly tripled in value, from £115 to £330 billion (+185% over the period). By comparison, over the same period total assets increased by 60.6% (from £7.1 to £11.5 trillion), PPE increased by 76.3% (from £500 to £879 billion), and market capitalisation increased by 88.5% from 2009<sup>79</sup> (from £1.3 to £2.4 trillion). This suggests that intangible assets grew at a faster pace than assets overall, physical assets and market capitalisation.

2.58 This is reflected in intangible assets share of total assets increasing over the period, as shown in Figure 5:

Figure 5: intangible assets as a share of total assets, FTSE 350 companies

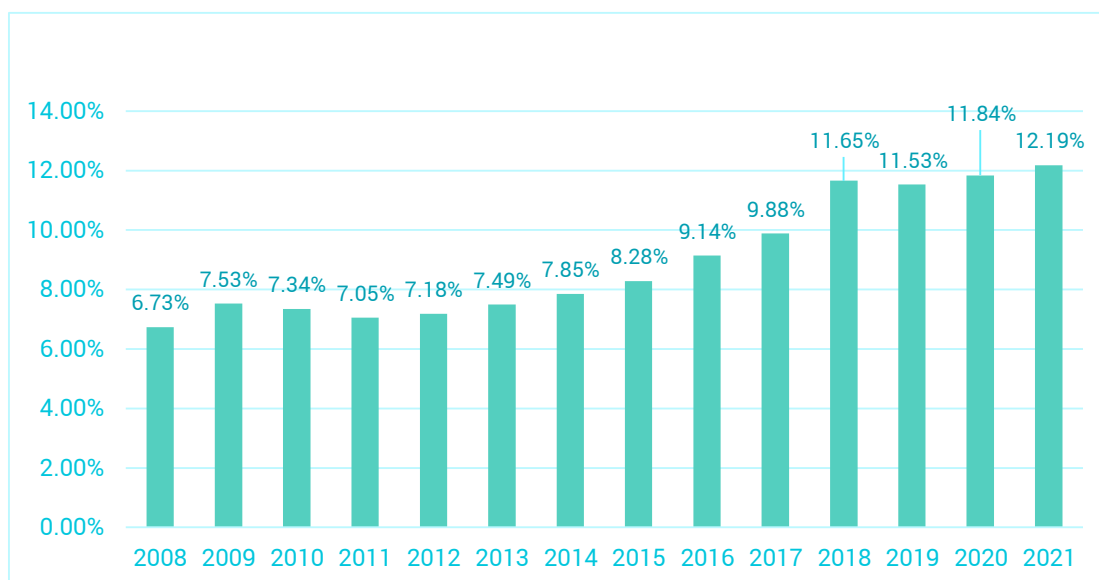


<sup>78</sup> We have chosen this time span due to data availability/reliability.

<sup>79</sup> We compared 2021 year-end market valuations with 2009 as in 2008 they were negatively affected by the financial crisis.

2.59 The rise in intangible assets is even more evident when excluding the financial sector (banks, insurance companies and financial services firms). Excluding the financial sector, over the 2008-2021 period intangible assets as a share of total assets nearly doubled, from 6.73% to 12.2% (see Figure 6).

Figure 6: intangible assets over total assets, FTSE 350 companies (excluding financial sector)



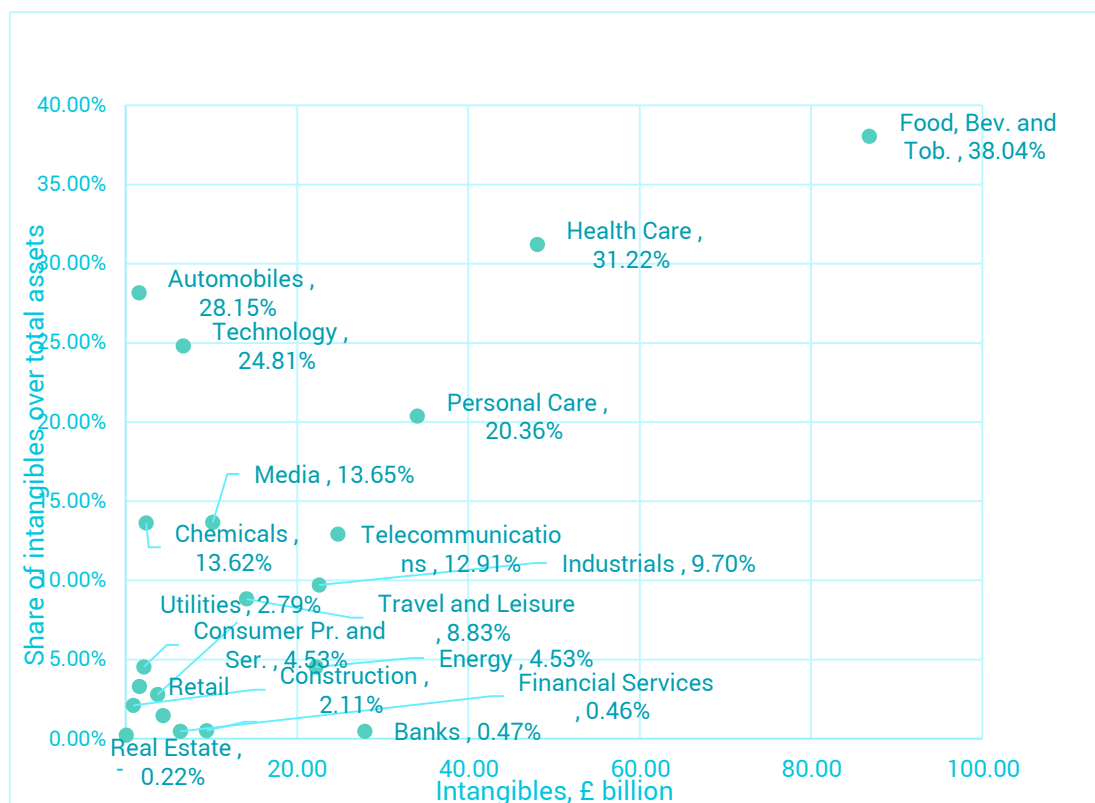
2.60 In fact, there are significant sector differences in the prevalence of intangible assets (see Figure 7). The graph plots the amount of intangibles on the balance sheet in £ billions against their share of total assets. The sector characterised by the highest amount of intangibles, both in absolute and relative terms, is Food, Beverages and Tobacco; this is largely attributable to the British American Tobacco (BAT) 2017 acquisition of Reynolds<sup>80</sup>, which was associated with the recognition of nearly £75 billion of trademarks.<sup>81</sup> The second largest industry (both in absolute and relative terms) is health care, which includes pharmaceutical companies like AstraZeneca and GSK, characterised by significant levels of R&D capitalisation, as well as expenses (see paragraph 2.61).

<sup>80</sup> See <https://www.bat.com/reynolds>

<sup>81</sup> See [BAT 2017 financial statements](#), pages 132 and following



Figure 7: Intangible assets by industry



Source: Reuters-Eikon. Industry classification: ICB (Super-sector).

- 2.61 These figures show that intangible assets are increasingly important on companies' balance sheets. However, and as discussed in paragraphs XX-XX, under the current accounting framework companies can only capitalise a relatively limited number of internally generated intangible assets. By contrast, capitalising intangible assets arising from a business combination is mandated at their acquisition date at fair value, suggesting that intangible assets are under-recognised on companies' balance sheets. In addition, except in the limited circumstances in which a company is permitted to and elects to use the revaluation model, a measurement gap is also likely to arise after initial recognition.
- 2.62 In addition, IAS 38's relatively restrictive recognition criteria haven't typically allowed companies to recognise intangibles belonging to asset classes that have emerged in recent years (such as "big data" or AI algorithms: see paragraphs XX-XX) or have required the expensing of others (such as training, advertising, human capital). As a consequence, the types of intangibles as well as their value on companies' balance sheets should be interpreted as a "lower bound", both in absolute terms and as a share of the total.
- 2.63 Analyses of financial statement information and additional data from Reuters-Eikon provided evidence suggesting that intangible assets are potentially missing from companies' balance sheets (see paragraphs XX - XX and XX - XX).
- 2.64 More in detail, we analysed FTSE 350 annual reports to look for evidence of granular information on intangible expenses. As discussed later in paragraphs XX-XX, a problem flagged by UK stakeholders about IAS 38 is the fact that the standard does not require detailed disclosures about expenses that may relate to intangibles. The analysis revealed that a majority of FTSE 350 companies do not disclose granular information about

intangible expenses, such as R&D, advertising, software development and training costs<sup>82</sup>. Using Reuters-Eikon data and individual financial statements, we found the following examples of such expenditures:

- a) Unilever, a customer goods company, in 2021 expensed over £6 billion in advertising costs<sup>83</sup>;
- b) Diageo plc, a food and beverage company, expenses roughly £2 billion per year on advertising<sup>84</sup>;
- c) 33 companies on the FTSE 350 expensed training costs, for a total amount of £406 million.
- d) **XX** FTSE 350 companies in 2021 expensed over £22 billion in R&D.

2.65 It can be argued that at least part of those intangible expenses is likely to be investments that companies are not allowed to capitalise under current IFRS requirements.

2.66 The academic literature uses the Perpetual Inventory Method (PIM)<sup>85</sup> to capitalise intangible expenses. Using the PIM for a selected number of companies to estimate the extent to which intangible assets are likely to be missing from companies' balance sheets, i.e. the recognition gap<sup>86</sup>, showed the following:

- a) Capitalised R&D costs for two major pharmaceutical companies, AstraZeneca (AZ) and GlaxoSmithKline (GSK), are likely higher in value<sup>87</sup> than what is currently recognised on their balance sheets:
  - i. Over the 2011-2020 period, AstraZeneca spent over £5 billion per year on average in R&D. Using 2001-2021 data we estimate that, assuming a 10% success rate<sup>88</sup>, if AZ were to capitalise these expenses, they would amount to over £3.7 billion additional intangible assets in 2021 (this figure takes into account depreciation and the success rate)<sup>89</sup>.
  - ii. Over the 2011-2021 period, GSK spent over £3.8 billion per year on average in R&D. Using 2001-2021 data we estimate that, assuming a 10% success rate, if GSK were to capitalise these expenses, they would

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82 The analysis was conducted using Reuters Eikon, Fame, Companies Watch and companies' financial statements.

83 See Unilever 2021 [financial statement](#), page 123.

84 Put link to [Diageo financial statements](#)

85 Using a time series of expenditures, the perpetual inventory method capitalise expenses by adding new investment to a stock of capital that is depreciated every period. Different techniques allow the calculation of initial values. Depreciation rates in the literature depend on the intangible asset considered. For branding, depreciation rates are typically assumed to be 50%. For R&D they are assumed to be 15%. For a generic intangible asset they are assumed to be 22%. See Villalonga, 2004; Peters and Taylor, 2017; Bongaerts, Kang and Van Dijk (2022).. **[Describe methodology]**

86 We should also note that intangible assets written on companies' balance sheets are likely subject to a measurement gap, in that they are not necessarily measured at their balance sheet date economic value. Unfortunately, estimates of any existing measurement gaps would be more difficult to provide.

87 For simplicity, in the analyses reported in 2.88 a), b) and c) only the recognition gap is considered.

88 Following Yamaguchi, Kaneko and Marukawa, 2021; Takebe, Imai and Ono, 2018.

89 The amortisation rate assumed in the calculation is 15%, following the literature; the calculation does not take into account potential impairment losses.

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amount to nearly £2.6 billion in 2021<sup>90</sup>.

- b) We capitalised training costs for Vodafone, a telecommunications company. Over the 2011-2021 period, Vodafone spent over £49 million on average per year in training. Using 2001-2021 data we estimate that, was Vodafone to capitalise these expenses, they would amount to roughly £715 million in 2021<sup>91</sup>.
- c) We capitalised advertising costs for Unilever, a consumer goods company. Over the 2012-2021 period, Unilever spent over £7.3 billion on average per year in advertising. Using 2012-2021 data we estimate that, was Unilever to capitalise these expenses, they would amount to almost £16 billion in 2021<sup>92</sup>.

2.67 Additional analysis of Reuters-Eikon data and individual financial statements revealed that some companies recognise customer relations arising from business combinations. For example, the London Stock Exchange Group has recognised £8.7 billion in customer relationships following their acquisition of Refinitiv and Tradeweb in 2021.

2.68 These figures and analyses suggest that some intangible assets are likely missing from companies' balance sheets, and that, more granular information about intangible expenses could help users obtain better estimates of the size of intangible assets held by companies.

## Unlisted companies

2.69 We also estimated the prevalence of intangible assets in a sample of 28 large unlisted companies applying IFRS<sup>93</sup>. An analysis of companies' financial statements has revealed that as of 2020 year-end these companies had £4.7 billion in intangible assets (excluding goodwill). Total assets for these companies totalled nearly £300 billion (£126 billion excluding two life insurance companies that did not hold any intangible assets), suggesting that the share of intangible over total assets was 1.6% (3.7% excluding financial companies).

2.70 The lower share of intangible as a percentage of total assets for unlisted companies than that for listed companies (see paragraphs XX-XX) may be attributable to the lower degree of M&A activity taking place among private companies.

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<sup>90</sup> The amortisation rate assumed in the calculation is 15%, following the literature; the calculation does not take into account any potential impairment losses.

<sup>91</sup> The amortisation rate assumed in the calculation is 15%, following the literature; the calculation does not take into account any potential impairment losses.

<sup>92</sup> The amortisation rate assumed in the calculation is 45%, following the literature; the calculation does not take into account any potential impairment losses.

<sup>93</sup> The sample is: Arnold Clark Automobiles, Arup, Bestway, CDS Superstores, Domestic and general, Edrington Group, Euro Garages Ltd, Heathrow Airport Holdings Limited, INEOS Group Holdings, ISG, John Lewis PLC, KCA Deutag Alpha Limited, Matalan, Motor fuel group, Morson group, Nando's Group Holdings, Neptune Energy Group LTD, New look retail holdings Ltd, Pertemps Network Group Limited, Pension Insurance Corporation PLC, Reed, Rothesay Life Plc, Stonegate pub company, John swire & sons limited, Kemble Water Finance Ltd, The very group, THG, Vue International Bidco PLC.

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## Tracking to national level information

- 2.71 A comparison between FTSE 350 companies' and macroeconomic data suggests that some intangible assets are likely unaccounted for in individual companies' accounts.
- 2.72 Using the same method used in paragraphs XX-XX, we capitalised intangible investment at a national level. Assuming a 22% depreciation rate (the rate used for a "generic" intangible in the literature, see Villalonga, 2004) we estimate that as of 2019 year-end intangible assets at the UK national level were just above £670 billion.
- 2.73 As reported in Figure X, as of 2019 year-end intangible assets on FTSE 350 companies' balance sheets amounted to roughly £293 billion. This represents 43% of the estimated the stock of intangible capital based on ONS experimental data reported in paragraphs XX-XX.

Draft for comment

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## 3. Stakeholders' concerns with IAS 38

- 3.1 The following sections summarise the key themes emerging from more than 30 in person interviews with stakeholders and two round-table like discussion the team held with the UKEB Preparers Advisory Group (PAG)<sup>94</sup> and the Accounting Firms and Institutes Advisory Group (AFIAG)<sup>95,96</sup>. Appendix XX discusses the methodology used to conduct our research, including a breakdown of the respondents by category of stakeholder. When appropriate, stakeholders' views are compared and contrasted with the relevant literature in accounting and economics.
- 3.2 We will firstly focus on the problems with IAS 38 identified by stakeholders and then discuss opportunities for improvement flagged by the respondents. Some issues (materiality, prudence, relevance and reliability) are discussed in a separate section.

### “What’s wrong” with IAS 38: a literature-informed summary of stakeholders’ views

- 3.3 In this section we summarise the concerns stakeholders raised with the current accounting for intangible items. We also consider the reasons why current accounting may be difficult to change, or even perceived as favourable by some stakeholders. These concerns lay a foundation for the following section that considers opportunities for improvement in the accounting for intangible items
- 3.4 A key theme to emerge from interviews were that IAS 38 is an “old standard”. This topic was explored with interviewees and it appears that at its heart the issue is the growing disconnect between the language of IAS 38 and the evolving *Conceptual Framework*. Beyond this there were concerns about the lack of information about key intangibles in the financial statements, including their non-recognition, inconsistent accounting and the limited disclosure.

#### IAS 38 *Intangibles* is an “old standard”

“I do think IAS 38 has problems. The main problem is that it is an old Standard, based on an old conception of R&D. It doesn't help to deal with many intangibles that exist today.” (Academic)

“IAS 38 is an old standard, it is too general”. (Preparer)

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<sup>94</sup> More information about the PAG can be found [here](#).

<sup>95</sup> More information about the AFIAG can be found [here](#).

<sup>96</sup> While several themes overall consistent with the interview findings emerged from both discussions, it is important to note that members of the two groups raised different and sometimes contrasting views on what the issues with the standard are and did not agree on specific solutions to existing problems.

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- 3.5 IAS 38 was originally issued by the International Accounting Standards Committee in September 1998 (see paragraphs XX-XX). That Standard replaced IAS 9 Research and Development Costs, issued in 1993, which itself replaced an earlier version, Accounting for Research and Development Activities that had been issued in July 1978. As a consequence, the current standard in fact retains large sections originally written in the 1970s.
- 3.6 When asked what is wrong with intangibles, a common refrain from stakeholders was that “IAS 38 is an old standard” (Preparer). On its own the age of a standard is not a valid criticism, but this view seems to be underpinned by two specific concerns, that IAS 38 is outdated when considered in light of:
- a) the advances in technology and the economic changes experienced since the standard was developed and implemented for use by companies in the UK (see paragraphs XX-XX); and,
  - b) the recent developments in the Conceptual Framework underpinning international accounting standards.

### Advances in technology

- 3.7 The first concern is that IAS 38 has not kept pace with advances in technology. This is closely linked to the increasing importance of intangible capital in the economy, as evidenced in paragraphs XX-XX and to newly emerged intangible assets classes, as noted in paragraphs XX-XX<sup>97</sup>. On this issue one interviewee commented that “something needs to be done. The status quo is not acceptable. It is not a reflection of economic reality and not relevant to the value of the business. The economy will become more intangible over time.” (Auditor)
- 3.8 IAS 38 references specific intangible items, that were relevant at the time the standard and subsequent amendments were published. Because IAS 38 is a catch-all standard newly developed intangible assets are within its scope. However, the recognition and measurement specified in IAS 38 fails to capture the economics of most intangible assets, especially internally generated intangible assets. This remains true for new intangibles, such as artificial intelligence, algorithms and big data. This often leads companies to expensing all such items for financial reporting purposes.

### Advances in IASB’s Conceptual Framework

- 3.9 The second concern refers to changes in the conceptual framework that underpins the development of accounting standards, and a mismatch between how assets are treated in

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<sup>97</sup> Since the publication of IAS 38 in 1998, nearly 25 years ago, there have been significant developments in the world. To put this in context consider just a few of the technologies become mainstream in the last two decades:

- Smartphones (the first Apple iPhone was released in 2007)
- The rise of Artificial Intelligence, increasing reliance on algorithms and Big Data
- Easily accessible video calling (Skype launched in 2003)
- Video streaming (YouTube launched on 2005)
- Social media (Facebook launched in 2004)
- 3D printing
- Internet usage has grown from virtually 0 to over 50% of the world population
- The mainstreaming of hybrid and electric transportation.

Many of these changes relate directly to intangible items.

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the Conceptual Framework (revised in 2018) and in the standard itself. As one stakeholder noted “The [current] Conceptual Framework definition of an asset does seem to capture a lot more intangibles than are generally recognised under IAS 38.” (Standard Setter)<sup>98</sup>.

- 3.10 IAS 38 was based on a the *Framework for the Preparation and presentation of Financial Statements* (the *Framework*) developed in 1989. The definitional characteristics and recognition criteria in IAS 38, particularly the concepts of control and probability, are embedded from that *Conceptual Framework*. However, the *Conceptual Framework* revisions in 2018 are particularly relevant to these concerns, as they were partly driven by shareholder feedback during the second agenda consultation about the application of the conceptual framework to intangibles (discussed in paragraphs XX-XX).
- 3.11 The 1989 *Framework for the Preparation and presentation of Financial Statements* defined an asset as “A resource controlled by the entity as a result of past events and from which future economic benefits are expected **to flow** to the entity”. This definition is repeated in IAS 38, paragraph 8. The definition of an asset was changed in the 2018 *Conceptual Framework* to “A present economic resource controlled by the entity as a result of past events. An economic resource is **a right** that has the potential to produce economic benefits” (emphasis added).
- 3.12 Two changes to the language used in the Conceptual Framework to define an asset are of particular relevance for intangibles.
- a) The first is that in the new framework assets are based on economic resources, which manifest as rights. Of course, rights are themselves intangible, emphasising that intangibility is at the core of such assets.
- b) The second the deletion of ‘expected to flow’ from the definition of an asset, which emphasises that the economic benefit does not need to be certain, or even likely, in order to meet the definition of an asset.
- 3.13 This theme was reflected in some stakeholder interviews, particularly those who suggested that the distinction between tangible and intangible assets may no longer be as relevant as in the past. As one former standard setter noted “all assets are now “rights” so all assets are really intangible”. (see also XX).
- 3.14 The change in 3.12 b) in particular echoes one of the stakeholder’s views on intangible assets: “Intangibles are value drivers of firms. In fact, often the company may be making losses from an accounting perspective. But value is being created in things like employees, corporate culture, resources the company devotes into delivering future growth such as spending on R&D, Software, brand names, even CapEx (more broadly defined). All these have the potential to deliver value in the long run”. (Academic)
- 3.15 The removal of the requirement for an expected flow from the conceptual framework now means that it clashes with the recognition criteria of IAS 38: “An intangible asset shall be

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<sup>98</sup> The Conceptual Framework for Financial Reporting is a fundamental element of International Accounting Standards. While not a Standard itself: “The Conceptual Framework sets out the fundamental concepts for financial reporting that guide the Board in developing IFRS Standards. It helps to ensure that the Standards are conceptually consistent and that similar transactions are treated the same way, so as to provide useful information for investors, lenders and other creditors. The Conceptual Framework also assists companies in developing accounting policies when no IFRS Standard applies to a particular transaction, and more broadly, helps stakeholders to understand and interpret the Standards.” IFRS Conceptual Framework for Financial Reporting.

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recognised if, and only if: (a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity” (para. 21). With the reference to “probable”, understood in accounting to mean “more likely than not” (IFRS 5, Appendix A).

3.16 By contrast, the current *Conceptual Framework* refers to an asset having:

“the potential to produce economic benefits. For that potential to exist, it does not need to be certain, or even likely, that the right will produce economic benefits. It is only necessary that the right already exists and that, in at least one circumstance, it would produce for the entity economic benefits beyond those available to all other parties” (para 4.14)

“A right can meet the definition of an economic resource, and hence can be an asset, even if the probability that it will produce economic benefits is low” (para 4.15, emphasis added).

3.17 The revised conceptual framework also made amendments to the concept of control, so that the IAS 38 definition is now out of line with the new conceptual framework definition. IAS 38 states that “An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits.” (IAS 38, para 13). While this definition is similar to that found in the Conceptual Framework definition (para 4.20), IAS 38 goes on to heavily emphasise the need for legal rights to protect the intangible asset (see IAS 38 paras 14 and 15). This latter focus on legal rights is now out of step with the new Conceptual Framework, which notes that “control can also arise if an entity has other means of ensuring that it, and no other party, has the present ability to direct the use of the economic resource and obtain the benefits that may flow from it. For example, an entity could control a right to use know-how that is not in the public domain if the entity has access to the know-how and the present ability to keep the know-how secret, even if that know-how is not protected by a registered patent.” (Para 4.22).

3.18 Technology has seen rapid developments in the business environment with the introduction of brand-new business models as well as revolutionising the way business is conducted (see paragraphs XX-XX). These advances in technology and the recent changes to the conceptual framework form the foundation for concerns that IAS 38 takes too limited an approach to recognition of intangibles.

“I am nervous about having too many rules and trying to create bright lines. A principles-based approach is better. If you set a bright line people find ways to bend the rules. Principles usually leads to greater discipline in the accounting. I would prefer something that is more aligned with the conceptual framework. Is there really an asset here? Then we can think about the appropriate measurement?” (Investor)

3.19 Stakeholders clearly value the *Conceptual Framework* and the principles that it brings to the development of accounting standards. The importance of alignment between accounting standards and the conceptual framework was a clear theme that emerged from the stakeholder interviews.



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## Three specific problems

- 3.20 Beyond the *Conceptual Framework*, interviewees' main concerns about IAS 38 coalesce around three clear issues with the current accounting:
- a) Limited recognition of intangibles items
  - b) Inconsistent accounting, whether for:
    - i. different types of intangibles, e.g. research versus exploration;
    - ii. internally generated vs purchased intangibles; or
    - iii. intangibles versus other assets.
  - c) Disclosure, for both capitalised and expensed intangible items.
- 3.21 It is worth noting that stakeholders did not identify the gap between book value and market value of companies (see paragraphs XX-XX) as a key concern. As noted in paragraphs XX-XX, this has however been a significant area of note among academics, particularly Baruch Lev who has authored a number of books and articles focussed on this matter.
- 3.22 Even when asked, few interviewees identified this as a primary issue. For example, an academic noted: "I am not a fan of the theory that the gap between Book Value and Market Value is driven by intangibles. I do not believe perfect measuring of intangibles would lead to a perfect match between Book Value and Market Value." (Academic)

### Limited recognition

"We need to get behind the initiative to change IAS 38. The most important assets are missing from the balance sheet. The idea being that it is hard to say you are relevant when all the information on Intangibles is missing". (Auditor)

- 3.23 Many stakeholders interviewed reflected concerns that IAS 38 rarely leads to recognition of internally generated intangibles, an issue also widely commented on in the literature on the topic. For example Barker et al. (2020<sup>99</sup>, pg. 2):

"Intangibles are an increasing component of the assets of modern firms. They include knowledge assets acquired through research and development, human capital developed by investing in employees, the value in supply chains and product distribution systems, brands, software investments, and the organisation of the business. Few of these intangibles appear as assets on balance sheets, leading to increasing calls for reform"

- 3.24 Almost all stakeholders commented that the prohibition on capitalisation of certain expenditures that could otherwise be deemed as contributing to an intangible asset, fails to capture useful information about many intangible items.

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<sup>99</sup> [This paper (which when reviewed was a working paper) has subsequently been published as Barker, R., Lennard, A., Penman, S., & Teixeira, A., (2022) Accounting for intangible assets: suggested solutions, *Accounting and Business Research*, 52:6, 601-630, DOI: 10.1080/00014788.2021.1938963, references will be rechecked against the final paper an updated]

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- 3.25 This was expressed in a number of ways from different stakeholders, for example:
- a) “The current accounting standard is not fit for purpose. There are lots of intangibles that should also be captured. There are “real” intangibles that are ignored in the financial statements even before you think about “brand” and “reputation” (Preparer)
  - b) “Genuine investment is being expensed.” (Standard Setter)
  - c) “Requirements to expense marketing and workforce are problematic. If they meet the definition of an asset they should be capitalised.” (Auditor)
  - d) “We aren’t capturing good assets on the balance sheet” (Preparer)
- 3.26 It wasn’t just those involved in the production of financial statements who raised this, users also noted the lack of recognition of many intangibles. One analyst for example commented:
- “accounting is okay at dealing with intangibles that have strong rights associated with them. Where the accounting system fails is insights into how the entity is developing intangibles, e.g. the ability of the workforce or the building of brands. Insight into these internal intangibles would be useful. That information is lacking in accounting.” (Analyst)
- 3.27 In addition to these concerns a preparer noted that the requirement to generally expense spending on internally generated intangibles fails to distinguish between “good spending” (i.e. money spent on profitable projects) and “bad spending” (i.e. money spent on non-profitable ones). They also linked this to IAS 36 *Impairment of Assets*, arguing that even for capitalised expenditure companies were slow to write off under-performing assets.
- 3.28 A prepare noted “The intangibles and impairment standards are slightly broken, we need to come back to the users’ needs. Bad news can be hidden as you expense as you go. We would like to see a developed narrative on ongoing costs, and some of this captured as an asset.”
- 3.29 There is also concern about the inability for IAS 38 to account for more of the recent innovations such as algorithms, cryptocurrency or artificial intelligence, all of which may already, or could in the future, represent significant intangible value.
- “There has been a rise in intangibles, resilience, networks, brand value etc, and the accounting is bad at capturing this, along with the creative process. This problem will grow as the economy continues to move towards intangibles. If you want accounting to remain relevant there should be a solution.”
- 3.30 Given the pace of innovation in the intangible space it is hard to know what specific items will be relevant in the future. However, when explicitly asked, most interviewees from all stakeholder types agreed that “new intangibles” such as algorithms, big data and tech capital should be considered for greater recognition, as it is evident that they are a significant contributor to future economic benefits for some companies.
- 3.31 Stakeholders, particularly academics, identified a range of intangibles they thought IAS 38 currently failed to appropriately consider for recognition:

- a) “Trademarks and brands: IP business models are different. If you have a strong registered trademark portfolio. They are accessible and protectable. Core brands that are protected.” (Academic)
- b) “Virtually all our brands are missing from the balance sheet because they weren't acquired. And most of our value is now focussed on looking forward to developing the next generation products which has to expensed. But that is just the way the accounting is. We don't see analysts seeing this as a problem, but obviously this creates inconsistency between organic growth and inorganic growth. Comparisons of companies is more difficult.” (Preparer)
- c) “There is clearly a need for capturing more intangibles assets, things like carbon emissions rights.” (Academic)
- d) For high-tech companies cloud computing is a key asset that is not being captured. (Academic)

3.32 As already discussed in the economics section (paragraphs XX-XX), intangible assets are generally associated with better long-term performance and profitability – and therefore it can be argued information about intangible assets is important for capital allocation. Box 3 provides further evidence from desk-based research on an intangible asset that many companies deem strategic: the brand.

### Box 3: The effect of marketing and brands on companies' performance

- B11 Brands are an important source of competitive advantage, as often discussed in academic research.<sup>100</sup> However internally generated brands are prohibit from recognition under IAS 38.
- B12 By offering differentiated products that satisfy the specific needs of carefully targeted audiences, marketing has allowed some companies and industries to increase their profitability (Narver and Slater, 1990), reduce competitive threats in their target segments (Hooley, Greenley, Fahy and Cadogan, 2001) and obtain fair prices on capital markets (Kumar and Shah, 2009).
- B13 The intangible asset best associated with marketing is the brand. A brand is “a name, term, design, symbol, or a combination of them, intended to identify the goods or services of one seller or group of sellers and to differentiate them from competitors” (American Marketing Association, 1960) and the sum of any mental connections people have around these features (Brown 1992).
- B14 Existing research has found positive associations between brand and revenues as a company can use its brand to positively affect customer attitudes and purchasing behaviour (Morgan, Slotegraaf and Vorhies, 2009). De Oliveria (2015) found a positive return on investment for brand equity. Firms' market share is also positively associated with brands as they allow firms to retain customers more easily (Sharp, 2002) and increase the firm's customer base due to higher familiarity and better reputation (Stahl, 2010). Brand was also found to positively influence customer satisfaction (Gruca and Rego, 2005, Izzudin and Novandarii) and loyalty (Hung, 2008).

<sup>100</sup> In November 2022, for example, the Economist suggested that companies with strong brands will be able to face the perils of expected [stagflation](#).

B15	Strong and recognisable brands are found to enhance firms' performance on capital markets. In a study comparing a portfolio of companies owning the world's most-valuable brands to market benchmarks, Madden et al. (2005) find that a portfolio composed of companies with widely recognised brands provides returns above the market benchmark at a statistically significant level. Additionally, the same portfolio had a below-average market risk.
B16	Given their relevance, it is not surprising that firms invest huge amounts in building brands. According to ONS Experimental Statistics, annual investment in branding in the UK was over £26 billion in 2019, of which £7 billion internally generated and £19 billion purchased. Applying the Perpetual Inventory Method to ONS data (see paragraphs XX-XX) shows that capitalised branding investments was worth between £71 and £105 billion depending on the chosen depreciation rate as of 2021 year-end (see Villalonga, 2004).
B17	Nonetheless, measuring the value of brands can be tricky. For example, it is often difficult to separate brands from other intangible assets (such as customer relations or human capital), making the job of assessing their value complicated. The existence of formal property rights, such as patents and trademarks, can facilitate the measurements of a brand's value (Goodridge, Haskel and Wallis, 2014) but, as emphasised in Damodaran (2007) it can only be applied to certain types of marketing.

- 3.33 Even when expenditures on intangibles do meet the definition of an intangible asset, recognition of internally generated intangibles under IAS 38 is limited to the development phase (see paragraphs XX-XX). Some stakeholders considered that the criteria for entering the development phase are somewhat arbitrary and open to significant interpretation leading to substantially different accounting outcomes for different entities, even in the same industry. "Determining technical and commercial feasibility is always difficult". (Preparer)
- 3.34 Stakeholders identified this lack of recognition of some internally generated intangible assets contributes to the value relevance problem for financial statements. As noted by an investor, "the definition of value is broken. The value factor has underperformed since 2008. It is due to the rise of intangibles. Intangible-heavy companies look expensive based on a Price-to-Earnings ratio. People are updating the value definition that adds back research and development. They change the earnings and get a better value measure."
- 3.35 The issue of limited recognition was also noted by some PAG and most AFIAG members. Specifically AFIAG members noted the following:
- a) As the economy evolves and digital capital becomes more prevalent (see paragraphs XX-XX), companies will want to recognise more internally generated intangible assets, as they are a source of competitive advantage;
  - b) with reference to internally generated software, it was noted that the standard does not provide clear guidance on what is the unit of account or how to amortise this asset, making auditing tricky.

### Inconsistent accounting

- 3.36 As noted in paragraphs XX-XX, there are significant differences between the accounting for internally generated intangible assets (frequently expensed because they fail to meet

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the recognition criteria), and assets acquired externally, either purchased intangible assets (initially recognised at cost) and or intangible assets acquired through a business combination (initially recognised at fair value).

- 3.37 Stakeholders commented that these different recognition approaches lead to significant differences in the accounting for otherwise comparable companies, dependant on whether they have grown organically or via acquisition.
- 3.38 The following are reflective of the comments we heard:
- a) “We need to level the playing field with IFRS 3 *Business Combinations* [which allows capitalisation of a much wider range of intangibles]; IAS 38 should expand to capture key intangibles”. (Academic)
  - b) “A good place to start with this question could be with those intangibles that are only recognised through a business combination [IFRS 3]. Should these be recognised irrespective of whether they have been acquired or developed internally?” (Standard Setter)
  - c) “There is disparity [in the accounting for] acquisition growth and organic growth. I don’t think it changes decision making, but it can lead to confusion”. (Analyst)
- 3.39 The academic literature has also identified this issue, for example Barker et al. (2020, pg. 2):
- “Intangible assets from an acquisition such as brands, customer lists, research and even goodwill are indeed currently recognised. Why not those from firms investing internally to develop their brands, customer relations, and research?”
- 3.40 Stakeholders noted that there are also substantial differences in the accounting if the intangible item is captured by a different standard. IFRS 6 *Exploration for and Evaluation of Mineral Resources* permits many research costs to be capitalised. By contrast, IAS 38 research costs must always be expensed even though “there is a high degree of similarity between E&E and R&D”. (Auditor). Another stakeholder noted “Extractive industries provide an interesting contrast to accounting for intangibles generally, and certainly contradicts the approach taken to R&D. There is no reluctance to impair and the model seems to work there.” (Accountant)
- 3.41 Even where the accounting for intangibles is relatively clear, as is the case for research and development, there is evidence of inconsistent accounting between companies. Mazzi et al. (2019) observed that companies in their sample mostly did not adopt a consistent approach to the accounting treatment for research and development, with the majority of companies either fully or partly expensing, raising concerns about the usefulness of reporting. In addition, the authors noted that, in their interviewees’ opinion, the current framework leads to little comparability between companies growing organically and externally.
- 3.42 The theme of inconsistent accounting emerged from the PAG too. PAG members noted that different treatment of internally generated intangible assets under IAS 38 and assets acquired in a business combination in IFRS 3 could have a “behavioural impact” on companies’ management, such as giving an incentive to grow by acquisition or selectively embark on projects according to what could be recognised on the balance sheet. This

could lead to management's judgements and inconsistencies between companies' accounts.

3.43 Similarly, AFIAG members also commented on inconsistent accounting for intangibles under IAS 38. AFIAG members commented on how different companies approach the recognition of intangibles differently, thus leading to potential inconsistencies:

- d) It was noted that the threshold for recognising internally generated intangibles under IAS 38 is much lower than the one for recognising intangible assets in a business combination under IFRS, leading to inconsistencies between companies
- e) Some industries are more R&D intensive than others (such as pharmaceuticals) and in these industries some accounting practices/conventions have developed that may be inconsistent with other industries;
- f) Auditors see a difference between larger companies, who are perhaps more conservative in recognising internally generated intangibles, and start-ups ("AIM companies"), who are keener to capitalise;
- g) Internationally, different local GAAPs imply very different levels of disclosures about intangibles, hampering international comparability for companies with international operations.

### Limited disclosure

"We need better disclosure about both capitalisation and expensing" (Academic)

3.44 While there are a substantial number of disclosure requirements for recognised intangible assets under IAS 38, stakeholders expressed some dissatisfaction towards the rules governing these disclosures. As one stakeholder put it: "Current IAS 38 disclosure requirements are a confused mix" (Auditor). Another one stated that "If management think it is important they should be disclosing. But users are getting cynical, they want better information, and have got fed up asking for it. I think that accountants are supposed to make accounting understandable to the ordinary person. We shouldn't need experts to help understand the organisation." (Investor)

3.45 Stakeholders noted that there are virtually no requirements to disaggregate and provide granular information about intangible expenditure which is expensed. One interviewee for example indicated that "at the moment so much to do with intangibles is lumped together and this is problematic. Investors are trying to strip out the value of the information on intangibles from the financial statements. At the very least Cash flow provides you with the best starting information" (Investor). Given that most internal expenditure on intangibles is currently required to be expensed, we heard numerous comments that the current disclosure requirements are inadequate. For example:

- a) "Even if you continue to expense (but balance sheet recognition would be better) there isn't enough granularity in the disclosures. (Preparer)
- b) "The expenses are not disaggregated enough. You might see R&D and advertising. You won't see training." (Auditor)
- c) "If they expense you don't get information about why they expensed. Why were expenses not capitalised?" (Academic)

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- 3.46 Another theme that emerged is separability, as there are no requirements to disclose the thresholds companies use to capitalise expenses. For example:
- a) “Goodwill is a significant asset for serial acquirers. We tend to remove it to focus on the operating performance on the entity. ‘Other intangibles’ seems to be a big bucket of unknown stuff. We don’t have a lot of clarity on when things are being capitalised and when they are not, what decisions are they making, what valuation methodology are they using to value the item on the balance sheet. The amortisation tends to be clearer.” (Investor)
  - b) “It is difficult to ascertain the policies that entities are using for recognition of intangibles. Sales, general and administrative expenses is a claimed investment but we don’t get clarity. There is no one size fits all.” (Investor)
- 3.47 Many of these themes have also been discussed in the academic literature.
- 3.48 For example, Barker et al. (2020) note that “IAS 38 also requires the disclosure of additional information about research and development activities. However, entities must disclose the aggregate amount of research and development expenditure recognised as an expense during the period. This is a mixture of research expense, development amortisation and any impairment expense.”
- 3.49 Qualitative research by Mazzi et al. (2019), also based on stakeholders’ interviews, noted that “there was general agreement that mandatory disclosure in IAS 38 is minimal and often boiler-plated disclosure on R&D expense and capitalisation. There is a desire for greater disclosure, which would underpin any capitalisation decision based on the six criteria.”
- 3.50 They go on, “We find that references to R&D-related terms are, in general, minimal in company annual reports, ... [and] varies significantly in length and location in the annual report. The interviews ...confirm a demand for more disclosure, especially when development costs are capitalised. Thus... companies are encouraged to provide clearer and greater levels of disclosure than that currently provided.” (Mazzi et al., 2019, pg 9 – summary of stakeholders’ views, 16 interviewees)
- 3.51 Disclosure has a recurring theme in discussions with stakeholders and it likely to be key to any future standard setting in this area. Not only does it come from all stakeholders’ categories, but also it emerged that it has driven stakeholders’ (and users in particular) away from financial disclosures, hunting for the information they need elsewhere.
- 3.52 An academic stated that “Accounting researchers tend to look for information outside of the annual report, to find relevant material information that can’t be found in the annual report.”
- 3.53 Users indicated that they sourced information on intangibles from other sources, with one noting that “Users looking at smaller companies may feel they get an advantage from private information”. (User)
- “Nothing is captured when it comes to intangibles.” (Auditor)
- 3.54 Limited disclosures was also noted as an issue by PAG and AFIAG members.

## Support for the current approach

- 3.55 Though many concerns with the accounting for intangibles under IAS 38 were identified by stakeholders, some identified reasons why there may be support for maintaining the current approach to accounting for intangibles under IAS 38.
- 3.56 Some stakeholders observed that the current accounting was not particularly problematic for users, with a common theme that information could be obtained from other sources.

“On one level there is not a problem. Investors use financial information along with other information to form their positions. The investment market takes a sceptical view of accounting information, it is the product of a range of assumptions and also incomplete. When you are valuing a company you do not start with a balance sheet, and in many ways the market is already coping.” (User)

- 3.57 Others felt that any changes to the standard/current accounting would be too difficult or lengthy to implement.
- a) “Intangibles are intrinsically linked to so many other parts of the business and it is very hard to untangle them.” (User)
  - b) “I think that the current approach is fairly decent. Say Coke, marketing will bolster its value, but it will make the accounts very messy and investors would just strip it out. Return on assets is a good measure.” (User)
  - c) “Developing a new standard on Intangibles is likely to take 20 years” (Auditor)
- 3.58 There was some support for the current approach at the PAG. PAG members overall agreed that IAS 38 has a high threshold for recognition that precludes that potentially precludes some intangible assets from being recognised on companies’ balance sheets (as noted in paragraph XX). Some of them suggested that this high threshold was not a problem because it reflected the difficulty in attributing future economic benefits to intangible assets or because intangibles are difficult to identify and evaluate individually. They suggested that any change to the recognition and measurement intangibles might be particularly problematic for smaller, less resourced, businesses.

## Management’s stewardship

- 3.59 Some interviewees suggested that there may be resistance to changing the current approach to accounting for intangibles. This is both because the current accounting is considered relatively “easy”, and reduces the need for impairment tests. Also, there is a view that under the status quo preparers have the ability to manage company KPIs while at the same time investing in intangible items without management being accountable for their investment decisions over the longer term (as most investments are expensed).
- 3.60 Expensing expenditure on intangibles as incurred means that future earnings do not have to be matched with the related amortisation of any intangibles acquired. This may allow an element of profit management, e.g. by inflating future profitability, albeit at the cost of current profitability. But often management argue (and users accept) that the expenditure on intangibles is not a “real expense” or at the very least is a “one-off” that should be ignored when calculating certain analytical metrics.



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- 3.61 The expensing of intangibles can also cause a number of important profitability measures to be inflated over time. Specifically measures tied to return on assets and return of equity. This is because the investment in intangibles that is expensed (in previous periods) is missing from the ratio denominator.
- 3.62 These arguments are reflected in stakeholders' comments:
- a) "Companies are not interested in capitalising, life is easier, no need to impairment test." (Accountant)
  - b) "Results are the most important measure. Preparers want to present this in the best possible light. The current standard allows organisations to choose how much to spend (expense) on research and development etc. By not capitalising Return on Investment looks better and there are no shocks from impairment. Also you can smooth income." (Preparer)
- 3.63 One academic also noted that auditors may also have an incentive to maintain the current approach in order not to incur higher costs:
- "Auditors are conservative. Even if a company might want to capitalise auditors don't have the resources and expertise to test the capitalisation, so they push towards expense. And it is even worse the more "exotic" the intangibles. It is all very well to think about prepares and users, but auditors are an important part of the process." (Academic)
- 3.64 Similar arguments appear in the academic literature on the topic. For example, Baruch Lev in his book "Intangibles – Management, Measurement and Reporting" (2001), observes that both managers might prefer the "US GAAP-mandated expensing of practically all investments in intangibles" (pg 88). because it allows management to inflate future profit, and protect themselves against the embarrassment associated with impairing bad investments. His arguments are equally relevant to the IFRS Accounting Standard environment where the majority of expenditure on internally generated intangibles is expensed.
- 3.65 Lev (2001) also turns his attention to users (analysts), who he argues often believe that they obtain from managers (and presumably other private sources) sufficient information about a firms' innovation activities. "In fact, public disclosure in financial reports of such information may strip them of privileged information" (pg. 91)<sup>101</sup>.

## Stakeholders' concerns - in summary

- 3.66 Stakeholders raised a range of concerns about the accounting for intangibles under IAS 38. A common refrain was that IAS 38 was an old standard, which seemed to reflect concerns that it was no longer in line with the requirements of the *Conceptual Framework*.
- 3.67 Building from this, stakeholders identified limited recognition of intangibles, inconsistent accounting for internally generated and acquired intangibles under IAS 38 and in

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<sup>101</sup> This is not intended to suggest these are valid arguments for not changing the accounting from a standard setting perspective, rather they may give context to some arguments put forward to maintain the status quo.

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comparison with other IFRS Accounting Standards, and limited disclosure as significant issues.

Draft for comment

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## 4. Stakeholders' suggestions for potential improvements: opportunities and challenges

"We would argue that better accounting would provide better information. Consistency and clarity will help." (*Investor*)

- 4.1 This section outlines a range of stakeholder suggestions to improve the accounting for intangible items highlighted during the research. Some of the challenges raised related to those suggestions are also considered. As previously noted, this report simply outlines the perspectives of various UK stakeholders; it does not provide the UKEB's views on potential solutions for accounting for intangibles.
- 4.2 Given the range of issues raised with accounting for intangibles flagged by stakeholders (see Section XX), it would appear that there is some expectation that the IASB's project will result in changes to the accounting for intangibles. As one preparer noted "the IASB needs to be ambitious with the project. This includes both recognition and measurement."<sup>102</sup> (*Preparer*)
- 4.3 The research did not find a consensus on the improvements expected by stakeholders; however, some themes were clearly identified. These can be summarised as:
- a) Fundamental considerations
    - i. The advantages of accrual accounting
    - ii. Removing differentiation between tangible and intangible items
    - iii. Separate accounting for different classes of intangibles
  - b) Enhanced Recognition
  - c) Measurement
    - i. Measurement at initial recognition

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<sup>102</sup> As noted in Section XX, there was broad consensus that the accounting for intangible assets under IAS 38 fails to provide investors with all the necessary information they need to allocate capital, thus not supporting the objective of general-purpose financial reporting as laid in the conceptual framework. Any proposed improvements will therefore have to bring the accounting back in line with this objective: "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors [users] in making decisions relating to providing resources to the entity" (Conceptual Framework, para 1.2). Users need information about the economic resources of the entity and how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's economic resources [stewardship] (Conceptual Framework, para 1.4). As Penman (2009) stated, "Accounting is utilitarian, so the accounting research question is one of developing accounting that handles intangible assets in a way that helps rather than hinders the analyst who wishes to value the firm." (p. 365).

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- ii. Subsequent measurement - cost model
  - iii. Subsequent measurement - fair value model
- d) Enhanced Disclosure
- i. More Granular Expenses
  - ii. Other Disclosures

4.4 Materiality also emerged as a theme. This is also explored in this section.

## Fundamental considerations

### The advantages of accrual accounting

4.5 An important cornerstone of accounting is that accrual accounting provides better information to support decision making by users<sup>103</sup>. Accrual accounting tells the story of the transaction and the flows arising from it. It records the cash flow (expenditure); capitalising that expenditure provides a record of what has been spent; amortisation gives an indication of how much value has been used up and the period over which the entity expects to continue to obtain benefits; and impairment can provide information about changes in expectations.

4.6 This fundamental concept and its application to intangibles was reflected in many of the stakeholder interviews, even in instances where they did not specifically use the term “accrual accounting”.

4.7 At a basic level, stakeholders indicated that information about intangibles is important, not only because they are becoming increasingly valuable but also because they are key drivers underpinning future profits and business value (see paragraphs XX-XX and XX-XX).

4.8 Enhancing recognition of intangibles, through capitalisation could be one way to provide useful information, as would enhanced recognition, as one investor noted “My plea for intangibles would be to require management to account for what is happening internally, we should be capturing internal activities. Core spending on intangibles should be capitalised. An alternative would be greater detail on the expenditure.”

4.9 Another user commented, in the context of research and development, that “When assessing a company, its Research and Development track record is important. If they capitalise on the balance sheet 10 billion and spend 40 billion, then you can assess better

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<sup>103</sup> This is reflected in the Conceptual Framework: “Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity’s economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because *information about a reporting entity’s economic resources and claims and changes in its economic resources and claims during a period provides a better basis for assessing the entity’s past and future performance than information solely about cash receipts and payments during that period.*” (Conceptual Framework, para 1.17, *emphasis added*).

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their return if the intention is for the accounting to reflect the nature of the business.”  
(Analyst)

- 4.10 This was also reflected by an auditor who noted that: “If you capitalise, at least you get information on [project] abandonment” through impairment (Auditor).
- 4.11 Stakeholders also commented on the general relevance of accrual accounting in the context of intangibles, while also pointing out related difficulties (see also paragraphs 4.74, 4.112 and 4.115) “An accrual accounting approach to intangibles would have greater predictive value. But a lot of it will ultimately be capitalised salaries which are very ‘grey’” (Investor)

## Removing differentiation between tangible and intangible items

- 4.12 One approach to proposed to addressing the concerns about the accounting requirement for intangibles suggested by a stakeholder was simply to abandon the concept of tangibles and intangibles.

“Intangibles is not a helpful distinction. You do not need to develop separate standards for tangible and intangible items” (former Standard Setter)<sup>104</sup>.

- 4.13 Rather than developing standards that are premised on the intangibility or otherwise of items, the accounting would focus on the nature of the item, and its use within the business, be that as for sale in the ordinary course of business (like inventory), a core element of ongoing operations (like property, plant and equipment) or as an investment (like investment property or certain financial instrument). This would effectively mean applying the existing accrual accounting recognition and measurement models that apply to tangible assets.

- 4.14 This view is in contrast to the earlier discussion of the economic characteristics that make intangibles different (see paragraphs XX-XX), and which suggests there is something fundamentally different about intangibles that may well be relevant to their accounting. Similarly, investors appear to consider intangible items as a stand-alone category too, because of those very same core characteristics outlined in [the economics section], which also make the accounting inherently more difficult<sup>105</sup>.

## Separate standards for different classes of intangibles

- 4.15 Another potential solution suggested by a preparer was the development of specific standards, or at least separate requirements within a single standard, for specific classes of intangibles: “Key types of intangibles around which standards (or requirements) could be developed are: (i) Relationship Intangibles (including workforce); (ii) Technology

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<sup>104</sup> A similar view is expressed by Barker et al. (2020, page 2).

<sup>105</sup> This resonates with the academic literature: “Intangible assets differ from tangible assets not just because they lack physical appearance but also because they are not identifiable such that contracts can be written on them for delivery. Explicit legal rights like patents and copyrights, and possibly brands, are exceptions (and these are booked to the balance sheet if purchased, as with any other asset), but ‘customer relationships’, ‘organization capital’, ‘knowledge assets’, ‘human capital’ and the like are not specific enough for a market price ever to be observed for them” (Penman, 2009, p. 359).

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related intangibles; (iii) Artistic Intangibles; (iv) Brand/trademark intangibles; and (v) Workforce and human capital.” (Preparer)<sup>106</sup>

- 4.16 This approach could risk reinforcing some of the concerns raised about current accounting for intangible items in the earlier sections. Developing standards (or even separate accounting) for specific categories of intangibles (no matter how broad) carries with it the risk that the identified items (or classes of items) may become irrelevant as the economy and business models develop and new types of intangibles arise (see paragraphs XX-XX). In addition, a classification based on type can potentially introduce inconsistencies between relatively similar types of assets (research and development under IAS 38 versus exploration and evaluation of mineral resources under IFRS 6 for instance).
- 4.17 These two views, abandoning any concept of differential accounting for intangibles and developing a range of standards for specific types of intangibles, represented the ends of a continuum of possible proposals suggested by stakeholders. However, most stakeholders tended to be focussed on broad principles that could be developed to enhance the accounting for intangibles.

## Enhanced recognition

“There is value in having the information about intangibles in the balance sheet.” (User)

“Now is the time to think about how to recognise and measure [intangibles]. Investors know this issue. They need more information.” (Academic)

- 4.18 The application of accrual accounting requires addressing when an intangible item should be recognised as an asset, how it should be measured initially and at subsequent periods. As previously noted, stakeholders identified the limited recognition of intangibles under IAS 38 as a problem with the standard.
- 4.19 Stakeholders identified a range of intangible items that could be recognised and capitalised<sup>107</sup> under a new accounting standard. The types of intangibles mentioned most frequently as candidates for possible recognition on the balance sheet were:
- the research component of R&D (in addition to development which can be recognised under IAS 38),
  - training,
  - certain marketing expenditure (that contribute to developing brand), and

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<sup>106</sup> A view that was shared by several stakeholders is that “a key intangible that should be reflected in the financial statements. There is value in the collective knowledge (assemblage) of the workforce.” (Preparer). See paragraphs XX-XX later in this section.

<sup>107</sup> For the avoidance of doubt, in this section when we refer to recognising and/or capitalising intangible assets we mean ‘internally generated intangible assets’. See paragraphs XX-XX on the recognition of intangible assets acquired externally (either purchased or in a business combination).

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- d) new intangibles such as databases and AI algorithms (less frequently mentioned when compared with others in this list).
- 4.20 Recognition of such items, which currently are generally prohibited from companies' balance sheets (see paragraphs XX-XX) but are clearly strategic to companies' future performance (see paragraphs XX-XX), could provide better information to users of the financial statements.
- 4.21 An auditor noted that stakeholders can "already get the data from alternative sources. It would be better to get it from inside the company. This enhances reliability." They also observed that "Once you put a number on the balance sheet it forces disclosure and commentary. It will get audited. It will get attention from regulators."
- 4.22 As discussed above (see paragraphs XX-XX), stakeholders requested a simpler approach to the criteria for recognition under IAS 38, which they viewed as problematic.
- 4.23 One academic thought "... at the moment the standard has many criteria for recognition. Why not just focus on future economic benefit? Users think the criteria are not clear. We don't understand how they can be applied consistently. Reduce the criteria or make them clearer."
- 4.24 This reflected views in other academic literature too. For example, a report published by ACCA and Deloitte in 2019 looking at the capitalisation of research and development expenditure<sup>108</sup> stated:
- "In relation to IAS 38, relaxing the criteria for capitalisation by reducing their number could be the way forward. This may help improve the value-relevance of financial information by more fully matching revenues with costs in the income statement through capitalising and amortising expense on value-creating assets such as R&D. Further, a reduction or simplification of the capitalisation criteria could also result in giving companies less room for exercising earnings management and increasing auditors' ability to assure any capitalised amounts."
- 4.25 Stakeholders argued that the first step to enhancing recognition would be to step back from the specific requirements in IAS 38 and instead take an approach more closely aligned with the current conceptual framework (see paragraphs XX-XX).
- 4.26 A specific example was provided by a preparer who commented on training delivered to a workforce to enhance their productivity. "An entity controls the collective workforce, if not any given individual. This information would be useful to capture and the conceptual framework seems to allow it."
- 4.27 A similar point was made by an auditor "Human capital resides in the workforce not the individual. It may be a budgetary expense, but if thought of as an investment this would change the thinking about this spending. Investments in intangibles makes the employee more efficient. Employees can enhance the value of an intangible."
- 4.28 A regulator noted that this approach to employee training would be consistent with the approach taken to customer relationships, "One of the arguments for not capitalising training costs is that your staff might leave, you don't control them, but equally our

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<sup>108</sup> Mazzi et al., 2019, pg 9

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customers aren't controlled, yet you recognise customer relations and lists in a business combination.”

- 4.29 In addition to training, advertising and marketing were also mentioned by stakeholders as expenditures on intangible items that could potentially be recognised as assets under the current Conceptual Framework and should be considered as part of a review of the accounting for intangibles.
- 4.30 An analyst noted that “Design and product design are key intangibles, along with market research and branding and business process engineering. These are key economic competencies that are not captured [by IAS 38].”

## Risks from enhanced recognition

- 4.31 However, stakeholders also identified potential risks with an enhanced recognition approach.

## Increased judgement

- 4.32 Users of financial statements raised concerns that enhancing recognition (and subsequent measurement) will introduce significant judgment into the accounting process – on whether there is an asset to recognise and its quantum. An investor said that “Useability of financial statements is impacted by uncertainties. If the financial accounting is not clear. You have to go down into the weeds.”
- 4.33 Another investor raised a similar concern “Any measure that uses estimates is open to interpretation, especially if the estimates are not disclosed. This makes life very confusing... Expensing the R&D does not necessarily make it harder to understand the company.”
- 4.34 A preparer was concerned that users may not fully understand the process through which intangibles are capitalised on the financial statements: “Preparers can see the philosophical merits of capitalisation but worry that there are few analysts who spend enough time to understand the process.” Whilst another highlighted the increase in legal risk arising from greater use of estimates: “Companies are concerned about litigation threat. Intangibles come with greater requirements to make estimates.”
- 4.35 These concerns are consistent with a regulator’s view that “while currently intangibles is not a highly recurrent area of concern, when questions do arise they are usually about the judgements and estimates that have been made, specifically impairment, valuation and useful life”. These are the very judgements that would become increasingly important if an enhanced recognition approach was incorporated in a future standard.
- 4.36 Some stakeholders expressed concerns about recognising the specific intangibles others identified:
- a) “It becomes difficult when we are talking about brand recognition. There is not a direct link between marketing and a sale, so, sure you could add the marketing, but it would complicate the process.” (Preparer).
  - b) “I would not support capitalisation of marketing or training as there is not real control.” (Investor)



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## Reduced comparability

- 4.37 A resulting reduction in comparability of information was also raised as a concern “Entities will start to come up with weird categories of intangibles if left to themselves which will harm comparability. There is weird aggregation of intangibles already.” (Academic)
- 4.38 A similar observation was made by a preparer who noted “Internally generated intangibles will introduce a lot of variability in the financial statements. This would be against the consistency approach.”
- 4.39 This is consistent with an analyst’s view that, “we could see the value of capitalisation but we also want consistency. Companies should not have too much subjectivity.”

## Reduced understandability

- 4.40 Stakeholders appear concerned that capitalising intangibles could make the financial statements harder to understand. As a preparer said “Each initiative in financial accounting seems to make things more complex. More detail may not be helpful, but we need to understand what users want.” (Preparer)
- 4.41 Some users were also concerned about the understandability of financial statements if intangibles were more widely recognised. “Capitalisation of intangibles would make accounts more difficult to understand. There is already material information about intangibles that is discoverable by reading the accounts. And putting the time in to read the accounts gives you an edge.” (Investor)
- 4.42 But users acknowledge there is a balance to be struck “Intangibles are important. There is a trade-off between understanding the reporting and accurately reflecting the underlying assets. The current accounting standards verge towards reliability.” (Investor)

## Prudence

- 4.43 Prudence was also raised as a concern, a preparer noted that “Some preparers are concerned that capitalisation of Intangibles, particularly at an early stage, is not prudent”. Related to this an auditor suggested that users of financial statements might have concerns that management would over-capitalise intangibles:
- “Investors seem to be the most sceptical. They tell me they are not interested in the valuation given by management. They seem concerned about management’s estimates. They seem concerned that management will massively over capitalise. And yes, there could be problems, but you can mitigate this.” (Auditor)

## UKEB Advisory Groups’ views

- 4.44 Enhanced recognition of intangibles was discussed by two of the UKEB’s Advisory Groups, the PAG and the AFIAG.
- 4.45 Both groups agreed that enhanced recognition could be a way forward (though AFIAG members noted that it would make auditing more challenging). The PAG noted that the recognition criteria of IAS 38 could be loosened to allow companies to recognise internally generated brands and employment/training costs. In particular, they noted training to deliver a specific contract should be capitalised. Within the PAG there was

however also disagreement with this view, as it was suggested that there may be inconsistencies between companies on the methods used and issues with the accuracy of the estimates.

Some PAG and AFIAG members identified difficulties to be considered when enhancing recognition, largely attributable to the inherent characteristics of intangible assets (see paragraphs XX-XX). PAG members noted that:

- a) recognition of intangibles among international companies may be tricky, for example because it may be complicated to attribute portions of a global brand to different geographies/jurisdictions;
- b) the entirety of operations may in theory contribute to supporting the value of a brand, so identifying what expenses should be capitalised would be tricky.

AFIAG members noted that:

- a) one difficulty with recognizing intangibles lies in working out when the transition from expenditure to capitalization really happens: When does development finish? When does amortization start? For assets that generate an income stream, at what point is an expense considered actual investment in the asset?

## Measurement

“Accountants often get too caught up on the best measurement.” (Investor)

- 4.46 Stakeholders expressed a range of views as to what they considered to be the best model for subsequent measurement of intangibles, particularly under an enhanced recognition approach.
- 4.47 Overwhelmingly, a cost-based measurement model was favoured for initial recognition of internally generated intangible assets. However, in the right circumstances stakeholders considered fair value could provide more relevant information going forward.

### Measurement at initial recognition

- 4.48 Stakeholders viewed capitalisation of costs related to intangibles as a way to address the issues of inconsistencies between the initial recognition of internally generated intangibles and other assets (including acquired intangibles, especially in a business combination
- 4.49 This is consistent with the requirements in IAS 38 for purchased intangibles and those limited number of internally generated intangible assets that can be recognised. No stakeholders raised specific concerns about the measurement approach under IAS 38 to measuring purchased items.
- 4.50 An academic noted that their own research with users of financial statements supported this view. “Our discussions with the users show they are happy to have these items on the balance sheet. But they want to know how the value has been determined. They do like

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capitalised R&D they don't want a US approach<sup>109</sup>. In the end, users feel they can only rely on cash flow because they don't trust the current mixed model. But they are interested in the useful life, they are interested in impairment. Balance sheet capitalisation does give useful signals.”

## Subsequent measurement – cost model

- 4.51 An important element of the cost model identified by stakeholders was that it would incorporate amortisation (unless an intangible was determined to have an indefinite useful life) together with impairment testing.
- 4.52 Stakeholders noted that organically replaced assets could have an indefinite useful life if they are “maintained”. As an investor commented, intangibles can be either “wasting (such as patents) or organically replaced (brand)”.
- 4.53 The potential for organically replacing the value in intangible assets complicates an approach based on the cost model as it means that while “putting things on the balance sheet could be a good solution...[companies] need to split out investment and maintenance.” (Auditor).
- 4.54 But it also potentially provides better information for users, as one analyst noted “At the end of the day cash flow is an ultimate truth, but better insights into the nature of the operating expenditure. Such as maintenance vs investment, would be interesting.”
- 4.55 This theme of maintenance versus investment in intangibles emerged in a number of specific contexts:
- a) “Some training is more like maintenance, make management explain why they are doing something.” (Investor).
  - b) “In many ways the value of the brand is captured in the gross margin of the product. Organic growth is hard to measure, how do you separate Marketing [enhancing] versus advertising [maintenance].” (Investor)
- 4.56 If a cost model for subsequent measurement were to be developed the hurdle of separating maintenance and investment costs would need to be considered in any future solutions.
- 4.57 Preparers of financial statements were the primary group of stakeholders who raised the most significant concerns about a cost model. One preparer argued that early-stage research by companies should not be capitalised because “it is too remote from a commercial product. What is the unit of account? Assigning costs to specific products can be very difficult. Companies and auditors would argue about any allocation as it is subjective.”
- 4.58 An auditor’s related view was: “The thing that is difficult is the relationship between input and output. For tangible items there is generally a relationship between cost and value, for intangibles this relationship breaks down.”

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<sup>109</sup> US GAAP prohibits, with limited exceptions, the capitalization of development costs. Development costs are capitalized under IFRS if certain criteria are met.

4.59 Both PAG and AFIAG members discussed the implementation of a cost model as a way forward, with members from both groups suggesting that this would be the preferred measurement model, in conjunction with a possible relaxation of recognition criteria (see paragraphs XX-XX). One AFIAG member suggested the use of a cost model for carbon credits. However, they noted there was still a question when capitalised intangibles, such as carbon credits should “hit the income statement” for example when they are used, or as they expire?”

## Subsequent measurement - fair value

4.60 An alternative approach to subsequent measurement of intangibles would be to use a fair value model. A few stakeholders expressed views about this approach, with no clear consensus emerging. In principle, fair value measurement would help address some issues that are specific to intangibles, eg. the potential disconnect between cost and expected economic benefit, the potential for significant changes in value over time, etc. In practice, fair value measurement for assets, not regularly traded in an organised market, generally tend to be complex and costly, due to the use of valuation models. In addition, a fair value approach has the potential to add volatility to companies’ balance sheets, something that leads to contrasting views among stakeholders (see paragraphs XX-XX).

4.61 Fair value measurement for intangibles as a potential solution was discussed by both PAG and AFIAG members.

a) PAG members suggested that fair value could be more appropriate for particular types of intangibles. For example, one PAG member noting that for brands (say, Coca-Cola) the fair value of the brand matters more than the capitalisation of amount previously spent or being spent every year to maintain brand awareness. PAG members noted that fair value may be needed by users, though one member raised the point that valuation methodologies should be notified and assessed by auditors.

b) AFIAG members suggested that the decision whether to use a cost or a fair value model may depend on the intended use of the asset: assets held to invest or speculate should be measured at fair value (an issue that is particularly relevant when considering crypto assets: see Box 2), whilst assets held to support operating activities should be measured at cost.

4.62 Some AFIAG members identified difficulties to be considered when applying a fair value model to intangible assets:

a) One AFIAG member noted that the value of most intangibles is difficult to identify as there must be at a minimum two willing counterparties (a buyer and a seller) to identify a transaction price, in absence of which measurement at fair value (when allowed) could be difficult.

b) One AFIAG member noted that some intangibles may be tricky to measure at fair value, for example how does one measure the market value of customer relationships? Using perhaps the salary of sales manager?

## Balancing relevance and reliability

4.63 Stakeholders noted that using a fair value model for subsequent measurement is about balancing ‘relevance and reliability’, a point that is also noted in the Conceptual

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Framework (Chapter 6) and academic literature<sup>110</sup>. Striking this balance is particularly important (and perhaps trickier) for intangible assets, given their inherent characteristics and the measurement difficulties linked to them (see paragraphs XX-XX)<sup>111</sup>.

4.64 A note of caution about fair valuing intangibles is offered by Stephen Penman in a 2009 paper titled “Accounting for Intangible Assets: There is Also an Income Statement”:

“A conjectured value of a conjectured asset that can never be validated with a market price is inherently speculative; value is in the mind of the beholder. This was so for the ‘intangible assets’ conjectured in the 1990s bubble for which there was no subsequent manifestation. Accounting runs into trouble when speculative, conjectured values enter the financial statements, more so when the asset’s existence itself is conjectural.” (Penman, 2009, p. 359)

4.65 An analyst raised a similar concern: “For a lot of companies, intangible assets are the key assets, Coke has the brand of Coca-Cola for example. The problem is that no one knows the value, it is totally subjective and very hard to know what is right. This means it is not useful it is too easy to disagree with the value.”

4.66 An auditor noted that valuation issues arising from a lack of market data may become less problematic as markets are developing that could support the use of fair value measurement for some intangibles.

4.67 “Intangibles are seldom traded in markets. But what is starting to happen now, especially in the tech sector, people are buying businesses to get the IP or the employees. Transactions for intangibles are increasing and we are starting to get more market data”

### Cost versus benefit

4.68 A preparer noted “There is a question of cost/benefit when it comes to using fair value. But accountants should be comfortable with fair value, we use it in a number of standards where it is necessary to make estimates. Defined Benefits and Share Based Payments for example. We should look to the valuers to come up with consistent models for valuation.”

4.69 Preparers particularly face a cost-benefit trade-off, with a fair value model likely to be more costly to implement but also potentially more beneficial for investor decision making<sup>112</sup>. As one academic noted “There is a huge trade-off between relevance and

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<sup>110</sup> As noted in [Zavodny \(2021\)](#), “The debate about the trade-off between relevance and reliability most commonly addresses the measurement issue, in particular when deciding on the pros and cons of historical cost accounting vs. current value accounting. Historical cost accounting is relatively reliable since the cost of an asset or liability to a firm is usually a verifiable number that is less subject to errors of estimation bias, present in current value calculations. However, historical costs may be low in relevance. While cost may equal current value at the date of acquisition, the equality will be lost as current values change over time. Consequently, the relevance of current value accounting generally exceeds that of historical cost. But the need for estimates when conditions are not ideal opens current value accounting up to problems of reliability”. See also Liang and Riedl (2014), Fukui and Saito (2020).

<sup>111</sup> As noted in Schöndube-Pirchegger, B., Schöndube, J.R. (2017): “[The results of the paper] reflect that for some items reported in financial statements—certainly not for every single one—a trade-off between relevance and reliability exists. Ready examples besides traditional revenue recognition... **are fair value recognition for assets or capitalization of self-created intangibles.**” (Emphasis added).

<sup>112</sup> The Conceptual Framework notes that the information provided by measuring assets at fair value may have predictive value (para 6.32)

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reliability. Revaluing intangibles or writing them down can create valuation advantages.” (Academic)

## Volatility in the financial statements

- 4.70 While stakeholders noted that techniques for estimating fair value exist and new marketplaces would make fair value measurement easier, they were concerned that measuring intangibles at fair value would lead to higher volatility in the financial statements. In particular, preparers were concerned that users of financial statements would over-react to the volatility that arising from use of fair value measurement. A preparer argued that “Users will need to get comfortable with increased fluctuations in the value of balance sheets, and the consequential impact on P&L.”
- 4.71 Not all stakeholders considered added volatility to be negative. One academic stated that “Economic volatility is a reality when it comes to intangibles, this should be reflected in the financial statements.”

## Property rights

- 4.72 Some stakeholders suggested that a fair value model is more appropriate in the presence of well-defined property rights. “There are a range of intangibles that embody certain levels of ‘right’. Patents come with high level of protection and certainty. This makes fair value a clearer option. Other intangibles, like brand, have lower rights. A cost model would be more appropriate here.” (Auditor)
- 4.73 A preparer noted another issue to consider “Understanding rights and obligations is a key factor. For crypto-assets [and intangibles more generally] the terms and conditions are very variable. And understanding the contracts and terms is key.”
- 4.74 By contrast, an academic argued that while rights were important it was not a question of whether fair value should be used, but rather how it is used “If you use a valuation model this takes account of the strength of the rights.”<sup>113</sup>
- 4.75 It appears that while there is some support among stakeholders for a fair value approach, it would need to be considered in the context of the information that is available to support any valuations, and clarity over what is being valued.

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<sup>113</sup> Additionally, an academic stakeholder expressed concerns about the adoption of a fair value model across jurisdictions with different levels of economic and institutional development, a view that emerged from one interview only but we believe is worth flagging because of its broader relevance to IFRS accounting standards: “With regards to measurement I would stay with the cost model. Given the variety of intangibles a strict fair value model would be difficult and costly. Keep in mind that IFRS are used in over 100 countries. They don’t have the size of firms, or the international features of firms in London. The average preparer is not a FTSE350 entity. Many of the firms must be small. They will not have the resources to implement a complex standard. A lot of standard setting decisions are driven by very large firms, but we ignore the small firms that must also comply. Emerging markets even more so.” (Academic)

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## Enhanced disclosures<sup>114</sup>

“At the very least better expense recognition requirements that are more granular would support better stewardship and inform expectations about future growth.” (Preparer)

- 4.76 Enhanced disclosure was perhaps the strongest theme to emerge from the research. Some stakeholders considered enhanced disclosure an important adjunct to enhanced recognition and measurement. However, others considered enhanced disclosures on their own as sufficient improvement to the accounting for intangibles.
- 4.77 Given the focus on ‘accounting’ for intangibles most discussions about disclosure with stakeholders were in the context of the notes to the financial statements. It was acknowledged that management commentary could also be used to enhanced disclosure but there was a general assumption that an accounting solution would involve the notes to the financial statements.
- 4.78 Almost all stakeholders interviewed suggested that even if a new standard on intangible items doesn’t lead to greater recognition and measurement of intangibles, there is still significant scope for enhancing disclosures. In particular,
- a) stakeholders would like to see more granular information about intangible expenditures (see paragraphs XX-XX).
  - b) stakeholders also suggested including other types of disclosures, such as drivers of value linked to intangibles, and their related risks. These are discussed in paragraphs XX-XX.
- 4.79 Users specifically argued most strongly for improving disclosures, for many it would be fair to suggest that this was their primary recommendation with regards to accounting for intangibles.
- 4.80 It may be that enhancing disclosures is the most straight forward first step to be made to improve the accounting for intangible items. As one academic noted: “Obviously we need to consider recognition and measurement, but these are difficult. Disclosure is less ‘unpromising’”.
- 4.81 Both AFIAG and PAG members discussed disclosures about intangibles and agreed that they should be enhanced. PAG members noted that enhancing disclosures around intangibles may be a viable solution, though one PAG member though noted that information on intangibles may be commercially sensitive. AFIAG members supported the idea of enhancing disclosures, both in the notes to the financial statements and in the front-end. However, they called better guidance or definitions on how to report expenses more granularly as well as units of accounts to be used to facilitate auditing.

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<sup>114</sup> Unless otherwise noted, in this report by “disclosures” it is meant added disclosures/notes to the main financial statements. Some paragraphs or quotes discuss disclosures contained in the first half of the annual report; these are explicitly noted.

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## More granular expense disclosures

- 4.82 Stakeholders noted that there is significant scope for increasing the disclosure about the expenses related to intangibles in the income statement. Many stakeholders would like more granular disclosure about the types and nature of expenditure, including but not limited to specific information on marketing, IT, training, and research included in the notes to the financial statements.
- 4.83 The view that more granular disclosures would improve the accounting for intangibles was raised by virtually all users interviewed, for example:
- a) "We spend a lot of time trying to figure out the intangible spend... Enhanced disclosure on expenses would be useful, like a breakdown of research and development and clear identification of marketing expenses." (Analyst)
  - b) "Sell-side don't really care about what is in the balance sheet. It is retrospective, the value comes from the future. We just want better break downs of [expense] information to help us extrapolate." (Analyst)
  - c) "Forecasting cashflow is easier when we understand marketing spend." (Investor)
- 4.84 But this view wasn't just limited to users of financial information. Stakeholders from a variety of backgrounds shared similar views:
- a) "Maybe disaggregation of the profit and loss statement will help". (Auditor)
  - b) "I would rather see expenditure broken out more clearly." (Academic)
- 4.85 Users noted that they would like to be able to disaggregate information on expenditure that enhances a company's productive potential, from that which is simply for maintaining it:
- a) "I would like to see more information on the split between investment and maintenance. Then more information on the nature of the investment, then I can make more accurate estimates on useful life etc." (Analyst)
  - b) "We have seen research that splits [capital expenditure] and [operating expenditure] for intangibles. This is useful information in the tech field. But capitalisation could create more noise than signal." (Analyst)
- 4.86 Similar views can be found in the academic literature<sup>115</sup>. For example, Nixon's paper (previously referenced) notes that preparers believe:

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<sup>115</sup> "Presentation within the income statement is also important, to separate current expenses from investment activity. For example, expenditure that is intended to generate future cash flows, but is too uncertain to be shown as an asset in the balance sheet, should be separated from current expenditure. Similarly, the consequences of the resolution of an uncertainty, including impairments, conveys different information to that in current expenditures." (Barker et al. 2020, pg. 27)  
"The Institutional Shareholders' Committee (ISC) stated in a 1992 report that its members are not concerned about the accounting treatment of R&D expenditure provided that there is adequate disclosure to differentiate research



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“disclosure of information is the key factor determining the value that the capital markets attribute to a company’s R&D expenditure rather than its treatment; the tension between the prudence versus accruals concepts that preoccupy the accounting standard-setters is, in the view of respondents to this survey, of little relevance”.

- 4.87 Some stakeholders’ (in particular users’) preference for only enhancing the granularity of expenses disclosures was due to their preference for assessing a company via the cash generated and related profit and loss information. For example, one credit analyst said that “On a day-to-day basis, intangibles aren’t a huge issue for a credit analyst, because we are focussed on earnings and how it translates into cash flow. Our focus is on EBITDA and cash flow.”
- 4.88 Another investor noted that “I am not sure the balance sheet is as useful as the IASB thinks it is. Financial Markets are focussed on income if you look at the models. Impairments are too slow. And the drivers are too slow.” (Investor).

## Other types of disclosures

“There will always be limits on how much information the financial statements can convey to help investors assess future cash flows. Although the accounting system relies on assumptions about the future, it is limited to capturing transactions and events that have taken place. Management has information beyond that in the financial accounting system that can help investors estimate future cash flows.” (Barker et al. 2020, pg. 27)

- 4.89 Stakeholders wanted information in the notes that enabled users to understand the relationship between intangibles, whether capitalised or expensed, and a company’s business model. Further, they also considered better information on the company’s expectations as to whether it would maintain or enhance future cash flows as useful. They noted that to be able to draw further conclusions on such issues, enhanced disclosures around intangibles are needed (this was generally in addition to more granular expenses, discussed in paragraphs XX-XX).
- 4.90 The need for enhanced disclosures was shared by all the different types of stakeholder interviewed, for example:
- a) A preparer indicated that disclosures might offer a better way for companies to communicate about intangibles “the key issue around intangibles is understanding the reporting entity and the story it is telling, rather than running the accounts through a sieve. One size doesn’t fit all when it comes to the accounting. Better corporate reporting needs to focus on the narrative, rather than arguing so much about the balance sheet.”

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from development and to evaluate the productivity and effectiveness of the expenditure. Fifty-four per cent of respondents agreed that the more information provided on R&D expenditure the less important is the issue of accounting treatment although a significant minority (35%) disagreed.” (Nixon, 1997, p. 273)

“The majority of financial directors and senior company accountants do not associate any economic consequences with the treatment of R&D expenditure. For them disclosure of information is the key factor determining the value that the capital markets attribute to a company’s R&D expenditure rather than its treatment; the tension between the prudence versus accruals concepts that preoccupy the accounting standard-setters is, in the view of respondents to this survey, of little relevance to their R&D accounting.” (Nixon, 1997, p. 274)

- b) An auditor wanted to see “more non-financial measures into the disclosure.”
- c) An investor said “disclosure is incredibly useful when it gives you information on non-cash items. It is also important where there is subjectiveness to value.”
- d) A credit analyst observed that “For intangibles we are looking at other information as the number itself is not particularly useful. There are always qualitative factors that go into any rating. There will also be a governance assessment. And none of the can be a number in the balance sheet. The more complex the business the more information you need, a balance sheet is never particularly useful on its own”.
- e) While another user thought that “The real opportunity is not necessarily putting in a number in the balance sheet, but other indicators could be useful that support the business model. Every genuine investor would welcome better insights into drivers.”
- f) An investor said that, “We can see what you have invested, but we need more information on the relationship with expectations.”

4.91 A specific type of disclosure raised by stakeholders focussed on linking intangibles to related Key Performance Indicators (KPIs) through the notes:

- a) “Key drivers would be useful to disclose. For example, employee churn by division, or customer satisfaction (net promoter score).”
- b) “Identifying the KPIs the drive value and discussing them will be key.”
- c) “[Through the notes] you can start to create linkages between management objectives, intangibles (especially IP) and how this drives sustainability”.

4.92 If more intangibles were recognised on the balance sheet then including information on KPI’s may also help address users’ and auditors’ concerns about over-capitalisation. For example, management could link useful life as well as impairments directly to the drivers of value intangibles are expected to provide. As one investor noted “We should be tracking the relationship between expectations and outcomes” (Investor)

4.93 Stakeholders also considered information on these key drivers as central to linking financial reporting with future ESG reporting, and that these relationships would provide particularly useful information “ESG is value relevant, but the linkages to value are hard to establish. Intangibles are a good scorecard for the “S” in ESG. This is related to human capital and brand. What is the value driver for human capital? Perhaps turnover or [employee] satisfaction”. (Auditor)

4.94 Similarly, there is a link to stewardship “Internal management struggle with managing IP. Investors want to know about the portfolio of patents and trademarks, but they also want to know how the board is managing these key assets, who has responsibility. There is a strong link to stewardship.” (Academic)

4.95 Finally, stakeholders noted that disclosure in the notes to the financial statements (as opposed to, say, the management commentary or the strategic report) ensures that this information is audited:

- a) “The advantage of including this information in the financial statements (rather than management commentary) is that it is verified (audited) and it is relevant to the financial performance and position of the entity”. (Standard Setter)
- b) “Regulation and auditing are key as is timeliness. Anything disclosed should be very clearly tied to the financial statements. The notes should really clarify why things are being expensed and did it meet the requirements to be capitalised.” (User)
- c) “If the information is there it allows you to ask better questions you get better outcomes.” (Auditor)
- d) “Good disclosure is very useful particularly when it is comparative (horizontally and vertically). If you are forced to disclose something in the financial statements it gets more attention.” (Investor)

4.96 It is clear that disclosure is seen as a key to any future accounting standard on intangibles ensuring that users of financial statement assess this important element of the financial statement in a the broader context, and support better decision making.

## Materiality matters

“Users are not getting the useful information they want. Not enough relevant information, too much irrelevant information. You need to apply materiality better. Help us by focussing on what you think is important” (Investor)

4.97 The issue of materiality was raised in many interviews. As noted, increased granularity of disclosure was one of the strong themes to emerge from stakeholder interviews. 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 on a company.

- a) “There is a tension between granularity and materiality. Intangibles are important so would expect a higher level of granularity in the disclosures”. (Standard Setter)
- b) “Users don’t want to be overwhelmed with irrelevant information they want to see the core information through the eyes of management”. (Investor)

4.98 Stakeholders were asked how this could be balanced with concerns about information overload. It was commented 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.

4.99 A preparer felt that the IASB might need to provide more guidance on intangibles and materiality “Materiality is just a concept. The standard could specify disclosures that are considered material by nature. The important issue is identifying what users think is important.”

4.100 An auditor commented that the work underway by the ISSB on materiality might be more relevant to intangibles:

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“Regarding materiality: there is extensive work on thinking about materiality and ESG is likely to be the most relevant to these discussions. The ISSB standards talk constantly about enterprise value. This makes materiality a forward-looking estimate. The profession is going to have to figure out how to manage materiality assessments. This will translate really well to intangibles.”

- 4.101 An investor felt that the issue of materiality was a problem of application rather than definition “Materiality isn’t just a quantitative measure. The IASB definition is good, but people don’t apply it right. The application of materiality is a big part of the problem. They leave it up to the auditors, rather than management taking the lead”.
- 4.102 Intangibles by their nature raise a particular problem when considering materiality, items that may involve less cost can have a significant impact on value. As one academic stated “As for materiality, a company rebrand could be quite material and the impact of intangibles is outsized, data protection training is an example of something that could have an outsized impact.”
- 4.103 In this context some stakeholders expressed concerns about commercial sensitivity, but again stakeholders identified materiality as the overriding factor. As one user noted “There is always a trade-off between efficient allocation of capital and commercial sensitivity. Materiality is the key but is not done well currently.”
- 4.104 When asked about the areas of concern about the current accounting for intangibles a regulator noted that while currently intangibles is not a highly recurrent area of concern, when questions do arise they can include “Failure to provide material information on intangibles”
- 4.105 When it comes to intangibles and materiality it is perhaps best summarised by an investor who said of materiality:

“Less is not better, more is not better, better is better”

## Stakeholders’ suggestions - in summary

- 4.106 Stakeholders have identified a range of ways in which the accounting for intangibles could be enhanced, namely a strong desire to explore enhanced recognition for some intangibles, and an openness to considering fair value if factors support reliable measurement.
- 4.107 Enhanced disclosure is almost universally viewed as a requirement for any new accounting for intangibles, whether or not there is enhanced recognition. It is acknowledged that materiality will have to be carefully considered, but that simple quantitative approaches are not going to be enough to get the disclosure balance right.

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## 5. Conclusions

- 5.1 This report focussed on exploring the views of UK stakeholders on the accounting for intangibles. The UKEB has not yet formed its own views on this matter.
- 5.2 Concerns about the accounting for intangibles are not new. There have been consistent calls from stakeholders at each IASB agenda consultation to address the accounting for intangibles under IAS 38. At the heart of these concerns is the view that the accounting requirements do not reflect the economics when it comes to intangible items, and that this impacts the information available for decision making.
- 5.3 UK stakeholders who took part in this research raised a range of concerns about the accounting for intangibles under IAS 38. A common refrain was that the standard was old and no longer aligned with the requirements of the *Conceptual Framework*.
- 5.4 Building from this, stakeholders identified limited recognition, inconsistent accounting for intangibles both under IAS 38, and when compared with other IFRS accounting standards, limited disclosure, as significant issues.
- 5.5 Stakeholders believe that any new approach to accounting for intangibles should be well grounded in the *Conceptual Framework*. Also, they suggest that the accounting should be principles based, taking 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 possibility of future development of legal and other rights, and any related markets.
- 5.6 There also appears to be an appetite to explore enhanced recognition for some intangibles, and an openness to considering fair value measurement if circumstances support reliable measurement.
- 5.7 Enhanced disclosure is almost universally viewed as a requirement for any new accounting for intangibles, whether or not there is enhanced recognition. It is acknowledged that materiality will have to be carefully considered, but that simple quantitative approaches are not going to be enough to get the disclosure balance right.
- 5.8 Based on stakeholder feedback, 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, risks, useful life, contribution to the business model and value of assets.
- 5.9 The themes that emerged in this report will be explored further and reflected upon in light of future research the UKEB intends to undertake. Taken as a whole that body of research will support the UKEB in formulating its own views on accounting for intangibles and engaging with any future IASB project on the accounting for intangibles.

# Appendix A: Glossary [In progress]

Term	Description
AFIAG	UKEB's Accounting Firms and Institutes Advisory Group
CHS framework	The Corrado, Hulten and Sichel (2005 and 2006) Framework
<i>Conceptual Framework</i>	<i>Conceptual Framework for Financial Reporting (2018)</i>
EFRAG	European Financial Reporting Advisory Group
<i>Framework</i>	<i>Framework for the Preparation and presentation of Financial Statements (1989)</i>
FRC	The Financial Reporting Council
IAS 2	IAS 2 <i>Inventories</i>
IAS 12	IAS 12 <i>Income Taxes</i>
IAS 32	IAS 32 <i>Financial Instrument: Presentation</i>
IAS 38	IAS 38 <i>Intangible Assets</i>
IAS 39	IAS 39 <i>Financial Instruments: Recognition and Measurement</i>
IASB	International Accounting Standards Board
IFRS 3	IFRS 3 <i>Business Combinations</i>
IFRS 6	IFRS 6 <i>Exploration for and Evaluation of Mineral Resources</i>
IFRS 7	IFRS 7 <i>Financial Instruments: Disclosure</i>
IFRS 9	IFRS 9 <i>Financial Instruments</i>

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<b>Term</b>	<b>Description</b>
IFRS 16	IFRS 16 <i>Leases</i>
IFRS 15	IFRS 15 <i>Revenue from Contracts with Customers</i>
IFRS 17	IFRS 17 <i>Insurance Contracts</i>
ONS	The Office of National Statistics
PAG	UKEB's Preparers Advisory Group
PPE	Property, Plant and Equipment
UKEB	UK Endorsement Board

Draft for comment

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# Appendix B: Research methodology

1. This research is qualitative in nature. We conducted in-person or Microsoft Teams interviews with over 30 stakeholders, using a semi-structured interview approach and approaching stakeholders of different types (preparers, users, auditors, academics) to obtain a diverse sample. Interviews lasted between 60 and 90 minutes depending on the interviewee. The interview questions were developed jointly by the technical accounting and economics teams and the UKEB. They draw from the accounting and economics literature on the topic and leverage prior research work and expertise of those involved in the project.
2. Semi-structured interviews are an interview type widely used in qualitative research. It involves guiding the interviewee through a set of previously written open questions, the order of which might or might not vary. Researchers can occasionally add questions if needed, but overall follow the interview structure. Semi-structured interviews are typically used when interviewers cannot access the interviewee more than once, and typically last between 30 and 60 minutes. For a concise reference, see Jamshed (2014) (link: <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4194943/#ref6>), and references therein.
3. Interviews broadly covered the following topics:
  - a. Does the current accounting for intangibles work? What problems does the interviewee see with IAS 38?
  - b. Classification: does the current classification work? Are there intangible assets that should be economically important, should be recognised but currently don't appear on balance sheets?
  - c. Initial recognition: how to separate intangible expenses from investment? How to define control?
  - d. Subsequent measurement: what is the best model to account for intangibles?
  - e. Organic versus external growth: does the fact that intangibles are more easily recognised when purchased or in a business combination lead to a fair representation of the balance sheets of companies that grow internally?
  - f. Solutions: does IAS 38 need improvement or replacement? What solutions does the interviewee propose to improve IAS 38?
  - g. Economic consequences: are there unintended economic consequences springing from the current accounting practices, such as effects on companies' valuations, or incentives to companies' management to grow by acquisitions as oppose to organically?
4. Following the tenets of qualitative research methods (and in particular, grounded theory), we aimed to obtain a diverse sample of interviewees, to enable us to obtain a variety of insights. We therefore decided to interview different investor types investing in regions around the world. We drew up the list of potential interviewees in the following way:



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- a. The UKEB team conducted some initial research to identify stakeholder categories of interest
  - b. A number of interviewees were secured using personal pre-existing contacts
  - c. Several interviewees were contacted using cold calling/messaging
  - d. Some interviewees were reached out thanks to the suggestion of other interviewees (snowballing)
5. Speaking directly with different types of stakeholders afforded the UKEB the opportunity to gain insight beyond what could be collected via a standard survey format. Particularly this allowed us to:
- a. Understand the main problems related to the current accounting framework, and whether problems were perceived differently by different stakeholder types
  - b. Identify solutions that can be adopted to improve the current accounting framework, using a balanced view that takes into account the needs of different types of UK stakeholders
  - c. Take a multi-disciplinary approach to the issue, interviewing largely accountants, but also marketing/communication specialists, lawyers, economists, and statisticians
6. We collected observations until we reached 'theoretical saturation', that is, until it was evident that interviewing an additional investor was unlikely to generate any additional insights/themes (Aldiabat & Le Navenec, 2018; Charmaz, 2006). To encourage participation and frank discussion we committed to keeping responses anonymous. To analyse the data, we extracted common and divergent themes that emerged from the interviews using thematic analysis (Bryman, 2016, pages 586-9). We adopted this approach rather than one based on grounded theory (Charmaz, 2006; Strauss & Corbin, 1991; Thornberg & Charmaz, 2014), as the purpose of the research is not to create new theory.
7. After conducting a preliminary analysis of the qualitative data emerging from the interviews, the team decided to cross-validate the main themes emerging by engaging with two groups of stakeholders in a roundtable fashion. The secretariat briefly introduced the research to two different UKEB Advisory Groups, the Preparers Advisory Group (PAG) and the Accounting Firms and Institutes Advisory Group (AFIAG), to then ask them two main questions: what is wrong with IAS 38 and what could be done to improve it. The analysis was conducted to test the relevance of the themes already emerged and explore the existence of themes not identified during the interviews.

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# Appendix C: Participants [In progress]

[This appendix will include a high-level overview of the range of stakeholders interviewed as part of this research. We will also identify and thank individual stakeholders if they agree to be named].

Draft for comment

# Appendix D:References [In Progress]

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