Financial Reporting Council

Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

30 May 2014

Dear Hans

Re: Post-Implementation Review: IFRS 3 *Business Combinations*

We are pleased to respond to your request for information for the Post-Implementation Review of IFRS 3 *Business Combinations*.

In order to gather views from UK constituents, we held an outreach meeting in March which was attended by over 40 preparers, users and auditors. We have also held discussions with individual investors and preparers who have shared their views and experiences of the standard and drawn on FRC's experience from corporate reporting review. Our response has also been shaped by the findings of our research paper "Investor Views on Intangible Assets and their Amortisation". We attach a copy of this research for your information. For simplicity, we refer to all those who have shared their views with us, throughout whatever medium, as "respondents" in our answers to your questions.

Given the scope and importance of the standard and the widely drawn sources of evidence, a range of views were received, some positive and some negative. No single view is unanimously held. Our outreach activities do not allow us to place strict percentages on those holding specific views but, we have tried to present the views expressed and how concentrated or widespread they were held in a balanced way.

A very common response from preparers was to highlight the difficulties in determining many of the fair value measurement requirements of the standard, from valuing intangible assets that are not separable from the business to previously held equity interests on gaining control. Investors also understand these difficulties and are often sceptical of the reliability of the information provided; this scepticism often results in investors making significant adjustments to the information provided under IFRS 3.

It was striking in our outreach event that preparers highlighted the cost of separately identifying and measuring all intangible assets and auditors noted the significant challenge in auditing these valuations as they are often heavily based on management judgements, whilst many investors said they then ignored the financial information provided, removing it from their assessments of performance and position. This highlights significant doubts that the separate recognition and measurement of intangible assets, particularly those that are not separable from the business, would satisfy a cost/benefit assessment.

Aldwych House, 71-91 Aldwych, London WC2B 4HN Tel: +44 (0)20 7492 2300 Fax: +44 (0)20 7492 2399 www.frc.org.uk

The Financial Reporting Council Limited is a company limited by guarantee. Registered in England number 2486368. Registered office: as above.

A number of respondents question the way the standard was developed and consider that the 2008 version of IFRS 3 introduced significant complexity resulting in high compliance costs and the disclosure of detailed information that is often ignored by investors.

This view was similarly expressed in discussions of the disclosures required by the standard. It was noted that the standard requires many detailed disclosures but does not encourage the presentation of a holistic view of the investment and its subsequent performance, which would aid an assessment of management's stewardship and decision making.

The most widely expressed suggestions for improving the standard were:

- require the separate recognition and measurement of fewer intangible assets—this could be done by re-introducing the reliable measurement recognition criteria, particularly in respect of intangible assets that are not separable from the business;

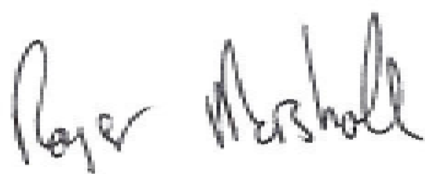
- reduce complexity and the use of judgemental valuations in areas such as stepped acquisitions, the treatment of non-controlling interests and partial disposals; and

- move to a model of disclosures that concentrates on high level objectives and provides for a holistic view of the investment and its performance, rather than specifying a list of detailed requirements.

Based on the suggestions for improvement of the standard emanating from our outreach, we suggest that the IASB undertakes a project to improve IFRS 3. More detailed responses are set out in the Appendix to this letter.

Should you have any questions in relation to this letter, please do not hesitate to contact either me or Jennifer Guest j.guest@frc.org.uk.

Yours sincerely



Roger Marshall
Director of the FRC and Chair of the Accounting Council
DDI: 020 7492 2429
Email: r.marshall@frc.org.uk

APPENDIX – Summary of responses to questions

Question 1 – **Background and experience**

Please tell us:

a) About your role in relation to business combinations (ie preparer of financial statements, auditor, valuation specials, user of financial statements and type of user, regulator, standard-setter, accounting professional body etc.)

b) Your principle jurisdiction. If you are a user of financial statements, which geographical regions do you follow or invest in?

c) Whether your involvement with business combinations accounting has been mainly with IFRS 3 (2004) or IFRS 3 (2008)

d) If you are a preparer of financial statements:

i. Whether your jurisdiction or company is recent adopter of IFRS and, if so, the year of adoption: and

ii With how many business combinations accounted for under IFRS has your organisation been involved since 2004 and what were the industries of the acquirees in those combinations.

e) If you are a user of financial statement, please briefly describe the main business combinations accounted for under IFRS that you have analysed since 2004 (for example, geographical regions in which those transactions took please, what were the industries of the acquires in those business combinations etc)

a) Through its Codes and Standards Division, the FRC sets standards for financial reporting in the UK and the Republic of Ireland. Through its Conduct Division, it reviews the financial statements of UK companies, concentrating on larger publicly traded companies that almost entirely apply IFRS.

In preparing this response, we have summarised the views expressed to us through our conduct, outreach and research activities.

b) United Kingdom, though our financial reporting standards are also applied in the Republic of Ireland.

c) IFRSs, including IFRS 3 (2004), were adopted in our jurisdiction for application from 1 January 2005 for the consolidated financial statements of all companies whose securities trade in a regulated market, according to the requirements of the IAS Regulation adopted by the European Union in 2002. IFRS 3 (2008) was adopted for application from 1 July 2009.

The UK has used the option under the IAS Regulation to permit the application of IFRSs as adopted by the EU by all other companies. Companies are also permitted to apply IFRSs as adopted by the EU for their individual financial statements.

Question 2 – **Definition of a business**

a) Are there benefits of having separate accounting treatments for business combinations and asset acquisitions? If so, what are those benefits?

b) What are the main practical implementation, auditing or enforcement challenges you face when assessing a transaction to determine whether it is a business? For the practical implementations challenges that you have indicated, what are the main considerations that you take into account in your assessment?

a) The primary benefit of having separate accounting treatments for business combinations and asset acquisitions is that they generally reflect the different economic substance of each type of transaction.

   Assets may be acquired within a corporate vehicle for tax or other regulatory reasons; but the transaction is, in substance, an asset acquisition and therefore should be treated as such, i.e. in the same way as a direct asset acquisition to ensure comparability of treatments irrespective of the legal form of the transaction.

   In particular, treating the transaction as an asset acquisition avoids the unnecessary and confusing complication of recognising deferred tax that, in turn, results in the recognition of goodwill as a balancing figure. The recognition of deferred tax on a transaction, such as the acquisition of an investment property within a corporate wrapper, when the transaction has been constructed that way to avoid taxation that would otherwise arise through sales of assets, would singularly fail to present the transaction's economic substance. It would also lead to an unnecessary burden of annual impairment reviews when it is obvious the goodwill has only arisen due to the deferred tax balance.

b) Respondents have noted that the definition of a business is too broad resulting in some transactions which are considered by the acquirer to be, in substance, asset acquisitions being treated as business combinations. This leads to a lack of comparability between direct asset acquisitions and assets acquired within a corporate vehicle.

   Differences in interpretations by preparers result in substantively similar transactions being treated as either business combinations or asset acquisitions.

   The definition of a business only requires that the set of activities and assets is "capable of being conducted and managed for the purpose of providing a return". This can lead some to conclude that transactions that are in substance asset acquisitions fall to be treated as business combinations under IFRS 3. Almost any combination of assets and any ancillary agreements are capable of providing a return, especially if the acquirer has the resources necessary to incorporate the acquisition into its existing processes.

   It was noted that these problems arise most commonly in the investment property, mineral exploration and pharmaceutical industries. Transactions in these industries often include the acquisition of a single substantive asset (e.g. a property, an exploration asset, research data) but the existence of ancillary agreements (such as management contracts) or other assets/liabilities which are insignificant to the transaction may be sufficient for the transaction to fall within the definition of a business combination.

For example, most investment properties will be acquired with tenants in place and many with maintenance, security and other ancillary agreements in place. Some might argue that all such transactions include the acquisition of inputs (the property itself, employees such as janitors or security guards etc), processes (e.g. through maintenance agreements) and outputs (the provision of rental space) but the substance is that an investment property has been acquired. As discussed above, treating such a transaction, as some do, as a business combination results in the recognition of deferred tax (even where the use of a "corporate wrapper" may mitigate the tax position) which in turn leads to the need to recognise a goodwill balance.

Greater clarity in the definitions or explanatory guidance and examples might reduce these interpretative differences, improve comparability and ensure that the accounting treatment properly reflects the substance of transactions.

Question 3 – **Fair value**

a) *To what extent is the information from the fair value measurements relevant and the information disclosed about fair value measurements sufficient? If there are deficiencies, that are they?*

b) *What have been the most significant valuation challenges in measuring fair value within the context of business combination accounting? What have been the most significant challenges when auditing or enforcing those fair value measurements?*

c) *Has fair value measurement been more challenging for particular elements for example, specific assets, liabilities, consideration etc?*

a) The information presented from the use of fair value measurements is generally considered to be relevant. Some respondents noted that the use of a comprehensive fair value approach and the resulting expensing of acquisition costs failed to provide investors with sufficient information in subsequent years to assess management's stewardship—acquisition costs form part of the outlay to acquire a business, so the total cost of the acquisition is not represented on the statement of financial position.

   Some respondents would like more information on valuation techniques and the inputs used, especially where the valuations are highly judgemental, such as intangible assets for which there is no active market.

   It was noted by some that a comparison of fair values to book values would provide significant insight into the valuation process and further insight into the acquired business, especially where assets were impaired.

   One investor noted that it is sometimes difficult to identify the full fair value of the true consideration paid where the acquired business had pre-existing debt. The acquisition of debt in this way may, in substance, be equivalent to an assumed liability which would form part of the consideration paid.

b) Mirroring investors' calls for further information on judgemental valuations, preparers and auditors noted that they would benefit from further guidance on determining appropriate valuation techniques.

Many noted that the process of determining valuations is complex and often costly. Preparers will often not have the expertise to perform valuations where there are no external market prices, predictions on future cash flows are judgemental and there is significant interaction between the assets. Where there are multiple intangible assets, such as brand names, customer relationships, customer lists, judgement is needed not only to value them individually but also to determine interrelationships.

Some noted that the valuations require a high level of management input in the determination of judgemental inputs and often the use of external experts (at significant additional cost) to advise on the use of models and to perform the valuations.

These observations led a number of preparers to question whether the costs of compliance with IFRS 3 exceed the benefits to users, since a number of investors noted that they disregard some of the intangible assets. The disregarded intangible assets are often those that have required the most judgemental and costly valuations. This highlights that there is significant doubt as to whether the right balance has been achieved between costs and benefits in the requirements of IFRS 3.

c) Areas of particular difficulty that were noted include:

- Intangible assets, especially those that are inseparable from the business and for which no external market prices or transactions exist. As noted below, a significant proportion of investors, preparers and auditors questioned whether such intangibles should be separately recognised at all, compounding the concerns over the costs of valuing them;

- Contingent consideration, especially because it often forms part of the total consideration due to the uncertainty of future performance which, in turn, makes valuation at the date of acquisition highly judgemental. The concerns over initial measurement are compounded by the requirement to recognise re-measurement gains and losses through profit or loss as the uncertainties are reduced over time; and

- Inventory—the measurement of inventory at fair value (an exit price), rather than original cost, distorts the measurement of subsequent performance compared to pre-acquisition performance and to the performance of the acquirer's pre-existing businesses.

Question 4 – **Separate recognition of intangible assets from goodwill and the accounting for negative goodwill**

a) Do you find separate recognition of intangible assets useful? If so, Why How does it contribute to your understanding and analysis of the acquired business? Do you think changes are needed, if so, what are they and why?

b) What are the main implementation, auditing or enforcement challenges in the separate recognition of intangible assets from goodwill? What do you think are the main causes of those challenges?

> c) *How useful do you find the recognition of negative good will in profit or loss and the disclosures about the underlying reasons why the transaction resulted in a gain?*

a) In principle, the separate recognition of at least some intangible assets is seen to be useful in that it provides greater understanding of the acquired business, the motivations for the acquisition and the drivers of future value.

However, our research into investors' views highlighted a significant level of disagreement with the requirements of IFRS 3 in this area. We enclose our research paper which shows:

- 48% of respondents to the research would prefer a different approach to intangible assets than currently required by IFRS 3, compared to 45% that supported it; and

- 74% of respondents to the research sometimes or always add back amortisation of intangible assets when assessing performance through the use of measures, such as earnings per share.

The concerns raised were strongly echoed by the majority of attendees at our outreach event and other parties we spoke to. The high level of dissatisfaction with the requirements of IFRS 3 to recognise all intangible assets was expressed by the majority of investors, preparers and auditors.

Central to many of the concerns raised is the need to recognise all intangible assets, irrespective of their nature or the ability to reliably measure their fair value. Our research identified a distinction made between what might be called "wasting" intangible assets and "organically replaced" intangible assets. The former group includes such intangible assets as licences, patents and software, whilst the latter includes such intangible assets as customer relationships and customer lists.

It is noteworthy that preparers find the valuation of non-separable intangible assets the most judgemental and costly. Auditors find them most difficult to audit as it is highly dependent on management judgement and investors regularly ignore the results of such valuations in their appraisals of financial performance and financial information.

Nearly all respondents were in favour of recognising "wasting" intangible assets but there was widespread concern on the recognition and measurement of "organically replaced" intangible assets. Concerns raised included:

- scepticism over the ability to determine a reliable (or verifiable) measure of fair value for intangible assets that are not separable from the business and, therefore there are no market prices or transactions for similar assets;

- scepticism over the ability to determine a non-arbitrary useful economic life for such assets for calculating subsequent amortisation; and

- the unrealistic distinction made between such assets and the residual goodwill—if they are not separable from the business they are not separable from goodwill.

One investor noted that the statement of financial performance is not intended to, nor could it ever, represent the full value of the business. If the rationale for recognising all intangible assets is to better reflect the business value then it is flawed.

To address these concerns, we recommend re-consideration of the decision in redrafting IFRS 3 in 2008 which effectively removed the reliable measurement condition for recognition, especially in respect of intangible assets that are not separable from the business. Re-instatement of such a condition could reduce unnecessary costs and the inclusion of highly judgemental measurements whilst still meeting the needs of the majority of users.

b) The key implementation challenges noted are:

- the identification of identifiable intangible assets. Not only is this seen as an onerous task in itself as the range of possible intangible assets is so wide and not all of these may have been explicitly considered in appraising the acquisition. However, it was noted that there appears to be diversity in practice in the intangible assets identified in different acquisitions. It was noted that management commentary may sometimes refer to resources that appear to meet the broad definition of intangible assets that are not separately recognised in the financial statements;

- as noted above, the measurement of intangible assets at fair value, (especially those that are not separable from the business for which there are no, or limited market transactions or prices) is often complex, costly and highly judgemental. Some investors are sceptical of the valuations attained and do not consider them reliable, which partly explains the widespread adjustments made to reported position and performance to remove their impact; and

- auditors noted that such judgements create significant challenges for them, given that significant inputs into any valuation model are based on management judgements and forecasts for which there is limited independent corroborative evidence.

c) We have received very few comments on the usefulness of recognising negative goodwill, but those we did receive were generally not positive. One suggestion for improving the accounting for a bargain purchase gain is to recognise this in OCI rather than profit or loss as it amounts to an upward revaluation of assets from cost to fair value.

Question 5 – **non-amortisation of goodwill and indefinite-life intangible assets**

a) How useful have you found information obtained from annually assessing goodwill and intangible assets with indefinite useful lives for impairment, and why?

b) Do you think that improvements are needed regarding the information provided by the impairment test? If so, what are they?

c) What are the main implementation, auditing or enforcement challenges in testing goodwill or intangible assets with indefinite useful lives for impairment, and why?

a) We have received mixed views on the usefulness of information from annually assessing goodwill for impairment, though the majority consider it to be the appropriate approach.

   Those in favour of the model noted that, compared to a policy of annual amortisation, it provided information to aid their assessment of management's stewardship of the entity's assets. Some investors noted that this normally provided confirmation of issues they had already noted but remained useful in bringing management to account for their investment decisions and subsequent actions. Some noted that annual amortisation can mask such information and that any period chosen for amortisation is likely to be arbitrary.

   However, even those in favour of annual impairment reviews without amortisation noted that the information on the impairment process is often insufficient for them to independently assess the results. In particular, it is not always clear how optimistic or otherwise estimates of future cash flows are, nor the basis for determining the discount rate applied.

   It was noted by one investor that the impact of changes in discount rates should be separated from the impact of changes in expected cash flows. In light of this comment and the fact that an impairment is effectively an adjustment to historic cost, we query whether the use of a current discount rate, rather than the historic rate at the date of acquisition, is appropriate. We recommend this issue is considered by the IASB as part of its wider research into the use of discount rates.

   Those that favoured annual amortisation considered its main benefit was the avoidance of "lumpy" impairment charges, though investors responded that as they are usually aware of the underlying issue creating the impairment this was not a concern.

   Some also questioned whether it is appropriate to consider recognising goodwill which has been effectively replaced over time by internally generated goodwill. The continued recognition of goodwill reduces comparability of the financial position between acquisitive and non-acquisitive businesses. On the other hand, annual amortisation would reduce the comparability of the financial performance across such businesses.

   One respondent noted that amortisation provided a link between the income generated from an acquisition and its cost; thus aiding subsequent assessments of the initial investment.

b) In performing its conduct activities, the FRC notes significant variation in the quality of disclosures provided on impairments. This issue is regularly identified in the reviews of financial statements we perform. Given many investors consider the recognition of impairments to provide important insights into management's stewardship these qualitative differences are important.

c) The main challenges noted by preparers and auditors are similar to those encountered in the initial valuation of non-separable intangible assets being:

   - the cost and complexity of performing annual reviews, especially the determination of appropriate discount rates. The determination of pre-tax discount rates is considered particularly difficult given most publicly available information used in deducing discount rates are post-tax;

- the need by some preparers to seek assistance from external advisors, reflecting the complexity and subjectivity of the calculations and increasing the costs of compliance further; and

- the judgemental nature of the calculations creates additional significant challenges for auditors and fuels investor scepticism, especially where disclosures about the process and inputs used are inadequate.

Additional concerns have been expressed about the subjectivity in allocating goodwill to existing cash-generating units and its reallocation following business restructuring. There are concerns that this may mask impairments in that, the cash flows predicted from an acquisition may not materialise, but no impairment is recognised due to the performance of other parts of the business.

It was noted by one preparer that, given an acquisition may have been absorbed into a profitable existing business for which internally generated goodwill has not been recognised, in many instances it is clear that no impairment loss will be recognised. In such instances, it is questionable whether a formal annual impairment review should be required and raises the question as to whether such reviews should be limited to instances where there are indicators of impairment or should not be required where it is clearly apparent no impairment loss will exist.

Question 6 – **Non-controlling interests**

a) *How useful is the information resulting from the presentation and measurement requirements for NCIs? Does the information resulting from those requirements reflect the claims on consolidated equity that are not attributable to the parent? If not, what improvements do you think are needed?*

b) *What are the main challenges in the accounting for NCIs, or auditing or enforcing such accounting? Please specify the measurement option under which those challenges arise?*

To help us assess your answer better, we would be grateful if you could please specify the measure option under which you account for NCIs that are present ownership interests and whether this measurement choice is made on an acquisition-by acquisition basis?

a) We have received few comments on the usefulness of the information resulting from the presentation and measurement of NCIs, however one might consider whether it is appropriate to allow a choice between measurement bases, and the potential reduction in comparability, when, in our experience, the majority of preparers use the proportionate interest method. This method is preferred as it avoids the additional complexity of determining the fair value of a minority stake in the absence of clear, independent market information.

   We also question the commonly held view that the resulting goodwill, when measuring NCI at its fair value, is “full” goodwill, since it results from the combination of the measurement of consideration for gaining control with the measurement of the NCI without a premium for gaining control.

b) The primary implementation challenge arises in the determination of the fair value of NCI when that option is taken. Given the most obvious evidence of fair value

is the consideration paid to gain control, it is often difficult to determine the premium paid for that control in deducing the fair value of the minority stake.

The measurement options available consequently affect the comparability of goodwill impairments. Where NCI is measured at fair value, it is not considered necessary to perform a notional grossing up of goodwill for the purposes of the impairment review. However where NCI is measured on a proportionate net asset basis, goodwill is grossed up on a proportionate basis. This results in the notional "full" goodwill amount being different to the "full" goodwill arising from measuring NCI at fair value.

Question 7 – **Step acquisitions and loss of control**

a) *How useful do you find the information resulting from the step acquisition guidance in IFRS 3? If any of the information is unhelpful, please explain why.*

b) *How useful do you find the information resulting from the accounting for a parent's retained investment upon the loss of control in a former subsidiary? If any of the information is unhelpful, please explain why?*

a) The comments we received on the usefulness of the information provided by the accounting treatment of piece-meal or stepped acquisitions were generally negative. The recognition of a gain or loss on any previously held equity interest was not considered useful by those investors that expressed a view. Their reasons for not finding the information useful were:

- the measurement of the gain or loss is generally not considered reliable, given it is generally not based on observable market prices. Given the amount paid to gain control of the acquired business will have included a premium to gain control it can only be used as the basis for valuation if a subjective adjustment is made to remove such a premium; and

- the gain or loss on the previously held equity stake represents a hypothetical gain or loss on disposal. As no such disposal has occurred, the gain or loss is clearly not realised and is generally ignored by investors in assessing the entity's profit or loss.

b) No comments were received on this specific point however, we suggest that the valuation challenges limit the reliability and hence usefulness of the information provided.

Question 8 – **Disclosures**

a) *Is other information needed to properly understand the effect of the acquisition on a group? If so, what information is needed and why would it be useful?*

b) *Is there information required to be disclosed that is not useful and that should not be required? Please explain why.*

c) *What are the main challenges to preparing, auditing or enforcing the disclosures required by IFRS 3 or by the related amendments and why?*

a) A number of respondents commented that the disclosures made following an acquisition are often insufficient for users to fully assess the performance of the

investment over time. A need for a more holistic view from the disclosures was identified; the required disclosures are very detailed and fail to provide an overall assessment of the investment and how it has performed compared to management's stated objectives in making the acquisition or the expectations of future performance at the time of the acquisition.

The assessment of future performance is made particularly difficult where goodwill is allocated to existing CGUs or the acquisition as a whole is absorbed into existing business lines.

On the other hand, some respondents noted that greater granularity would be useful in certain areas. However, it should be noted that one of the motivations for greater granularity was to allow users to remove the impact of the some of the accounting requirements of IFRS 3. For example, further detail on intangible assets would be welcomed by some investors as it would then allow them to adjust for some intangible assets (such as those that are not separable from the business) whilst retaining the accounting for others that are clearly wasting and will need to be replenished (such as licences and patents).

We welcome recent developments in the IASB's disclosure initiative; in particular, we welcome the encouragement for preparers to consider the order of disclosures and to consider if different disclosures would be best placed together. We believe that the development of a disclosure framework will lead to improvements in the quality of disclosures in the notes to the financial statements.

b) Some respondents noted that the detailed disclosure requirements can result in excessive disclosures that can obscure key information on the acquisition and inhibit any attempt to gain an overall view of the acquisition. The disclosures on receivables were identified as one example; we consider that it would be helpful if the IASB's disclosure initiative will result in changes to the way disclosures are written so that there are less detailed requirements and wording discourages disclosure when the information is not material.

c) The primary challenge is balancing the requirements of IFRS 3, with wording such as that in B64 which lists disclosures that "shall" be made, and the materiality thresholds of IAS 1 and IAS 8.

In its enforcement role, the FRC has identified wide variation in the quality of disclosures made.

Question 9 – **Other matters**

Are there other matters that you think the IASB should be aware of as it considers the PIR of IFRS 3?

The IASB is interested in:

a) *Understanding how useful the information that is provided by the Standard and the related amendments is, and whether improvements are needed and why;*

b) *Learning about practical implementation and whether from the perspective of applying, auditing or enforcing the Standard and the related amendments and*

c) *Any learning points for its standard-setting process.*

a) Concerns were raised over paragraph B55(a) and in particular the definitive statement that a contingent payment arrangement is for post-combination services if those payments are forfeited on termination of employment. Whilst it is widely accepted that such arrangements are commonly for services, there are occasions where the substance of the payments is that of contingent consideration for the acquisition.

Some have questioned the usefulness of charging transaction costs to profit or loss at the date of acquisition, given the costs are directly attributable to the acquisition. If such costs were to be capitalised, thus increasing the goodwill subject to annual impairment reviews, management could be more easily be held to account in subsequent periods for their total outlay in making an acquisition.

Respondents noted the following learning points for future standard setting:

- to ensure the information needs of investors remains the central test for changes to standards. Some respondents noted that the development of IFRS 3 (2008) concentrated on detailed changes to acquisition accounting that did not appear to reflect specific information needs of users. It is noteworthy that investors state that they often adjust the financial statements for items recognised in accordance with IFRS 3;

- it is important to ensure the overall objective of disclosures is consistent with the needs of users and clearly explained in the related standard. Setting out the objective of disclosures should encourage an holisitic view of the acquisition rather than compliance with individual detailed disclosures; and

- many of the changes made to IFRS 3 in 2008 arose as a result of a focus on expanding the use of fair value measurements rather than a focus on identified investors' needs.

Question 10 – **Effects**

From your point of view, which users of IFRS 3 and related amendments:

a) Represent benefits to users of financial statements, preparers, auditor and/or enforcers of financial information and why;

b) Have resulted in considerable unexpected costs to users of financial statements, preparers;

c) Have had an effect on how acquisitions are carried out (for example, and effect on contractual terms)?

a) Whilst some benefits of IFRS 3 were highlighted (and have been discussed above), most respondents considered the changes in 2008 did not constitute significant improvements; many of the areas of criticisms noted above relate to these changes, such as the effective removal of the recognition conditions in respect of intangible assets, the expensing of transaction costs and the accounting for stepped acquisitions and NCIs.

b) As discussed above, many aspects of accounting in accordance with IFRS 3 are considered complex and judgemental, resulting in high compliance costs and the

increased use of external advisors by preparers. Many investors note that the same factors increase their scepticism about the reliability of the information provided, leading to numerous amendments to remove the effect of information that was costly to prepare.

c) Some respondents noted that accounting for contingent consideration and the requirements of paragraph B55(a) has led to changes to contractual terms to ensure the accounting treatment was consistent with the economic substance of the agreed terms.

Financial Reporting Council

March 2014

FRC ARP Staff Research Report: Investor Views on Intangible Assets and their Amortisation

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

The FRC does not accept any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.

© The Financial Reporting Council Limited 2014
The Financial Reporting Council Limited is a company limited by guarantee. Registered in England number 2486368. Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.

Contents

1. Objective, Summary Findings and Conclusions 2

2. Intangible Assets Acquired in a Business Combination 7

3. Internally Generated Intangible Assets 11

4. Separately Acquired Intangible Assets 14

5. Adequacy of Presentation and Disclosure 15

6. Contact Details 19

FRC ARP Staff Research Report: Investor Views on Intangible Assets and their Amortisation

1. Objective, Summary Findings and Conclusions

1.1 Intangible assets have always been an important part of how businesses create value. Licences, patents and trademarks, and computer software are all recognised by companies and their investors as assets that, although lacking in physical substance, are vital to the generation of revenue.

1.2 In recognition of this fact, accounting standard setters have issued standards to address the accounting for such assets. In the UK for example, the Accounting Standards Board (ASB) issued FRS 10 *Goodwill and Intangible Assets* as far back as 1997 to address this very issue.

1.3 In 1998, the International Standards Accounting Committee (IASC) issued IAS 38 *Intangible Assets*. This was revised in 2004 and 2008 when the IASB issued and revised IFRS 3 *Business Combinations.* Under the latest revisions, it is assumed that all intangible assets acquired in a business combination will probably yield economic benefits and can be reliably measured, therefore they must be recognised. This has led to a larger number of intangible assets being recognised on business combinations, including assets such as customer lists and brands that are not usually recognised if internally generated.

1.4 However, controversy continues to surround the accounting for intangible assets, with some investors raising concerns about their separate recognition and subsequent measurement. This paper reports the results of a research project carried out by the Accounting and Reporting Policy team of the FRC to understand investor views on whether, from their perspective, the current requirements in IFRS produce useful and reliable information.

1.5 The research is not intended to cover all views on the accounting for intangible assets, concentrating as it does on those of investors. Furthermore, it shows that such investors do not have homogenous views from which self-evident conclusions can be drawn.

1.6 However, it does highlight a significant level of concern with the accounting for intangible assets amongst a number of investors. Some of these concerns arise from disagreement with the requirements of accounting standards whilst others appear to reflect dissatisfaction with the application of those standards, particularly in respect of disclosures.

1.7 This research is not intended to identify solutions to address these concerns. Rather it is intended to capture investors' views for the IASB to consider in identifying areas for further analysis and investigation. It is also relevant to

preparers as it highlights areas of potential improvement in communication with investors within the current frameworks.

1.8 The following paragraphs summarise the findings of the research. Where percentages are quoted they are given as a proportion of the entire population unless otherwise stated. For detailed analysis of responses to individual questions see sections 2 – 5 of this report. Details of research methods and timing of the research are included in the appendix to this report.

SUMMARY OF FINDINGS

Intangible assets acquired in a business combination

1.9 More than half of the respondents expressed a preference for accounting treatments in the statement of financial position (52%) and in the income statement (59%) different from those currently required by IAS 38.

1.10 The majority of those preferring a different treatment in the statement of financial position (37% of the total population) explained a distinction they make between different types of intangible asset. The key distinguishing characteristics as explained by these respondents were as follows:

- "wasting" intangible assets – these are separable from the entity, have finite useful lives and lead to identifiable future revenue streams. Examples include wireless spectrum and patents; and
- "organically replaced" intangible assets – investors raise doubts about whether these intangible assets are capable of being separated from the entity, are likely to have reliably determined useful lives, or be a source of future economic benefits that could be distinguished from the business as a whole. They stated that such intangible assets are replenished on an ongoing basis through the marketing and promotional expenditure of the company. Examples of such assets include customer lists and brands.

1.11 Although these investors believe that "wasting" intangible assets should be separately identified and capitalised, they are opposed to the separation of "organically replaced" intangible assets from goodwill.

1.12 Respondents that expressed a preference for an accounting treatment subsequent to initial recognition other than that required by IAS 38 suggested either:

- An accounting treatment that reflected the same distinction as noted above; wasting intangible assets to be amortised over their useful lives but organically replaced intangible assets to be subject to annual impairment reviews rather than periodic amortisation (33% of the total population); or
- All intangible assets acquired in a business combination to be subject to annual impairment reviews rather than periodic amortisation (26% of the total population).

1.13 We note that, in respect of intangible assets acquired in a business combination, IAS 38 does not permit different accounting treatments in response to the characteristics noted by respondents because:

- An intangible asset is considered identifiable if it is separable or it arises from legal or contractual rights;
- The probability recognition criterion (that is, the requirement that, in order to be recognised, it must be probable that the asset will yield economic benefits) is always considered to be satisfied; and
- The reliability measurement criterion is always considered to be met, on the basis that there is sufficient information to enable the asset to be measured reliably.

1.14 A majority of all respondents (74%) also noted that they add back amortisation charges on intangible assets acquired in a business combination when considering Earnings Per Share (EPS) ratios in some or all cases.

Internally generated intangible assets

1.15 A majority of respondents (63%) agreed with the requirement in IAS 38 to capitalise development costs as internally generated intangible assets (for example, software development costs).

1.16 However, 15% of respondents would also prefer that research costs were also capitalised. By contrast, 19% of respondents would prefer that all research and development costs were expensed.

1.17 It is interesting to note that both of these groups indicated similar reasons for their preferences. They noted that it is not clear to them from the disclosures given how the accounting policy is applied in practice – i.e. how research is distinguished from development and how the amounts capitalised have been determined such that they can assess themselves the reliability of that information. Some of those that favoured the retention of current requirements to capitalise only development costs also raised concerns on the quality of disclosures and their usefulness.

1.18 Some of these investors noted that companies did not appear to have a consistent approach to capitalisation of such assets. This uncertainty seems to have perpetuated a lack of trust amongst investors about the reliability of the measurement of internally generated intangible assets.

1.19 It is not clear whether these concerns arise from a failure by preparers to fully comply with the disclosure requirements of IAS 38 (and IAS 1 on accounting policies, judgements and sources of estimation uncertainty), a failure to present disclosures in an easily understandable way or shortcomings in the requirements themselves.

1.20 There were significantly more respondents in favour of the periodic amortisation of internally generated intangible assets (52%) than in favour of the same treatment of those acquired in a business combination (15%). This difference was not explained by respondents though it might reflect the difference in the nature of intangible assets that are, in practice, recognised in the two situations given the significantly higher recognition criteria set for internally generated intangible assets.

Separately acquired intangible assets

1.21 The vast majority of investors (89%) agreed with the capitalisation of separately acquired intangible assets and 56% agreed that annual amortisation was the correct treatment in the income statement.

1.22 Once again, this contrasts with views expressed on intangible assets recognised in a business combination or internally generated. This difference may reflect the nature of intangible assets that are, in practice, usually separately acquired. It may be the case that these tend to be “wasting assets” as described above. Some respondents cited the availability of a clear transaction price to support their views, which might suggest more reliable measurement in these cases.

Disclosures

1.23 Most investors expressed concerns on the quality of disclosures with some respondents requesting disclosures that are currently already required by IFRS. For example, some noted that a reconciliation of carrying amounts of intangible assets should be provided by class of intangible asset in a single table as is provided for fixed assets.

1.24 Other investors requested that detailed information on the objective of a business combination and intangible assets acquired should be provided for the investors to be able to perform post-acquisition reviews. These investors, in particular, asked for extra information on the basis for the valuation of such intangible assets and any assumptions used in calculating them.

1.25 Given that these requests refer to information that is already subject to current IFRS requirements, it would suggest that either preparers are failing to comply with these requirements or that the information provided is not presented with sufficient detail and/or clarity to meet user needs.

Investor response to disclosures provided

1.26 As mentioned above, a majority of investors (74%) stated that when they did have information on amortisation of intangible assets acquired in a business combination they tended to add this back to the EPS ratios they use to assess company profitability. The main reason cited was to compensate for amortisation of “organically replaced” intangible assets. By contrast, investors noted that they didn’t have the information on amortisation of internally generated intangible assets to consider similar adjustments for them.

CONCLUSIONS

1.27 This research has identified a significant level of concern amongst, at least some, investors on the accounting for intangible assets, especially those acquired in a business combination and the quality of accompanying disclosures.

1.28 As preliminary research it is not possible to draw definitive conclusions or to make clear recommendations on changes to IFRS. However, some tentative conclusions can be drawn.

1.29 The views of those investors that distinguish between “wasting” and “organically replaced” intangible assets contrast with the requirements of IFRS 3 and IAS 38 that require all intangible assets acquired in a business combination to be treated in the same way. The distinguishing characteristics the investors identify would “filter out” some intangible assets that are internally generated as the recognition criteria will include consideration of probable future economic benefits and reliable measurement. By effectively removing these hurdles for intangible assets acquired in a business combination IAS 38 does not permit a similar response.

1.30 This leads some investors to add back all amortisation even where they would prefer to only add back amortisation on “organically replaced” intangible assets which some consider to double count the cost as maintenance costs (i.e. marketing and promotional costs) also impact on reported profits.

1.31 Their views might also be interpreted as indicating a different opinion as to what constitutes an identifiable intangible asset when compared to IAS 38. These investors appear to equate identifiability with separability, whilst IAS 38 considers an intangible asset to be identifiable if it is separable or if it arises from legal or contractual rights.

1.32 It would appear reasonable to conclude that these areas are worthy of further detailed analysis and re-consideration.

1.33 There is also concern amongst respondents on the quality of company specific disclosures on intangible assets especially with regards to the rationale for capitalisation of internally generated intangible assets. Additional details on intangible assets acquired in a business combination are also thought necessary to meet user needs. However, as many of these disclosures are currently required it is not clear whether these concerns arise from a failure to fully comply with IFRS or to provide the information in such a way that is clear and easily accessible to readers.

1.34 Preparers should consider whether the form and content of the disclosures given is adequate to meet investor needs.

2. Intangible Assets Acquired in a Business Combination

Should intangible assets acquired in a business combination be included in the statement of financial position?

Always	Never	Other alternative treatment	Unsure/ No view	Total
12	2	12	1	27
45%	7%	45%	3%	100%

How should intangible assets acquired in a business combination be treated in the income statement in order to provide useful information to users of financial statements?

Amortise over UEL and assess for impairment	Do not amortise but assess for impairment	Other alternative treatment	Unsure/ No view	Total
4	7	9	7	27
15%	26%	33%	26%	100%

2.1 We asked investors whether, given the option, they would include separately identifiable intangible assets arising from business combination transactions in the statement of financial position. Investors were split between: (i) those who would always take this approach (45%); and (ii) those who opted for other ways of accounting for such intangible assets (52%).

2.2 Investors in the first category believed that including intangible assets arising from business combination transactions ensured transparency for investors about the assets acquired and the price paid. They went on to note the importance of being able to back test the management's assertions about the objectives behind the transaction through sufficient disclosures.

2.3 Investors who proposed alternative treatments of intangible assets acquired as a result of business combination transactions proposed the following:

a. A majority of these investors (37% of the overall population) proposed separation of intangible assets into "wasting" intangible assets, which they proposed should be recognised separately, and "organically replaced" intangible assets, which they proposed should be subsumed within goodwill;
b. One of these investors proposed that all intangible assets acquired as a result of business combination transactions should be subsumed within goodwill. This investor went on to propose the inclusion of disclosure notes in subsequent years' financial statements on goodwill with sufficient information to be able to perform post-acquisition reviews on management's objectives of the business combination; and

c. One investor proposed that such intangibles should be disclosed during the initial announcement of the transaction. However, this investor saw no purpose in subsequent slicing of what they saw as sunk costs and preferred to write it off.

2.4 A small minority (7%) stated that no intangible assets acquired in a business combination transaction should be recognised as separate assets in the statement of financial position. These investors believed that disclosure of such intangible assets was sufficient. When they were subsequently asked how they would account for the related proportion of the purchase price, these investors were willing to include these intangibles if they were subsumed in goodwill.

"Wasting" vs "Organically replaced" intangible assets

Some investors put forward the view that intangible assets acquired in a business combination transaction can be differentiated into two different types: (1) "wasting" and (2) "organically replaced".

Investors termed separable intangible assets with finite useful lives and identifiable future revenue streams (e.g. wireless spectrum) as "wasting" intangible assets. They differentiated these "wasting" intangible assets from those that arise from and are renewed through the company conducting its day-to-day business (e.g. customer lists and brands) which they termed as "organically replaced" intangible assets.

Investors who make this differentiation take the view that "wasting" intangible assets have identifiable useful economic lives and revenue streams that are separate from any other asset. As such, they consider these intangible assets to be assets in their own right that should be identified separately from goodwill.

By contrast, they consider "organically replaced" intangible assets as needing to be replenished on an ongoing basis by the acquiring company through marketing and promotion. They therefore viewed the "organically replaced" intangible assets as a part of the acquired goodwill and do not agree that these should be separated out.

2.5 When asked which treatment of intangible assets arising from business combination transactions in the income statement would best reflect investor's needs, the "organically replaced" and "wasting" intangible assets differentiation was also evident in the responses.

2.6 The largest group (33%) of investors stated that they would apply a different approach to the treatment of such intangible assets in the income statement. These investors put forward their preferred accounting treatment for "wasting" intangible assets (amortised over their useful economic lives) and "organically replaced" intangible assets (annual impairment assessment). They took the view that:

a. It is difficult to ascertain a reliable estimate of the useful life for some intangible assets such as brands and customer lists and hence impairment testing is more relevant.
b. Intangible assets such as brands and customer lists require additional annual expenditure on marketing and promotions for the acquiring company to maintain the asset and to charge amortisation would be double counting.
c. Intangible assets such as brands and customer lists should be treated in the same way as goodwill and, hence, assessed for impairment on an annual basis.

2.7 Just over a quarter (26%) of investors would not amortise any intangible assets acquired in a business combination but instead assess them for impairment annually. Their reasons for adopting this approach included:

a. Such items are similar in nature to goodwill and it was not obvious what cash-relevant running costs or reinvestment costs would be represented by the amortisation; or
b. Most investors focus on the transaction as a whole and do not look at the detailed list of purchase price allocations (PPA) which are "just a fiction that neither the company nor its advisers really look at".

2.8 By contrast, a minority (15%) of investors preferred to amortise intangible assets arising from a business combination transaction over their useful economic life and assess them for impairment on an on-going basis. One of these investors believed that the PPA process leads to clarity – a finite life and separately identified costs – which justified this approach for such assets. However, others in this group qualified their answer by stating that they would only take this approach if there was a clear view of the useful life of the intangible assets. For example, one such investor stated that "brands would never be assumed to have finite lives. Brands would be considered to have infinite lives and treated in the same manner as goodwill…If the asset has a finite useful life a charge must be made for wasting of the asset in use…Amortisation is preferable to testing for impairment as the latter introduces increased manager discretion into the valuation of assets and is an opaque procedure (which also varies internationally). Impairment arising from M&A can effectively reward overpaying in an acquisition, as impairment is 1) tax-deductible and 2) usually treated by analysts as 'one-off'."

2.9 The above results on accounting for intangible assets on the primary statements were replicated when investors were asked how they treated intangible assets and their amortisation for the purposes of company valuation or performance ratios they used.

2.10 A majority of investors (74%) stated that when considering the EPS ratios they (always or sometimes) added back amortisation on intangible assets acquired in a business combination for the following reasons:

a. Amortisation on “organically replaced” intangible assets (e.g. brands and customer lists) double counts expenditure on advertising and promotion by the company to maintain these assets. This reason does not apply to amortisation on “wasting” intangible assets (e.g. copyright material and wireless spectrum) which are similar to actual capital expenditure to buy a fixed asset. When there was insufficient information to separate the two types of intangible assets, investors noted that they added back all intangible asset amortisation even if they would prefer to be more discriminating;
b. To aid comparison of acquisitive companies and non-acquisitive companies;
c. To remove the effect of amortisation on intangible assets where they cannot identify/trackback to an acquisition/specific asset due to the lack of disclosure;
d. Amortisation is misleading as it has no cash effect; and
e. Intangible assets acquired as a result of business combinations should be subsumed within goodwill, the separation is arbitrary and the amortisation period is also arbitrary.

2.11 The questionnaire provided an opportunity after each question for investors to explain the reasons for the answers they provided. It was notable how many of the comments conveyed a sceptical view of accounting for intangible assets arising from business combination transactions in general. One investor’s comment encapsulated the distrust noted by a large number of the other participants in the research. He stated that, “the treatment of intangible assets in M&A accounting can effectively reward overpaying. Lack of disclosure is the problem: the difference between tangible assets acquired and the price paid is effectively lumped together and coined ‘intangibles’, with little clarity of how these assets will generate revenues”. Such comments were often followed by requests for further information on the nature of the intangible assets acquired and the difference they are likely to make to the company’s profitability.

2.12 Investors use the business combination disclosures to assess management’s stewardship of the company and its resources. A number stated that it was important for them to understand management’s rationale for undertaking particular business combination transactions in context of the assets acquired and the benefits arising from the use of those assets in the combined business. Performing a test of subsequent performance against management’s objectives for particular business combinations was one of the ways they assessed management’s stewardship of the business.

2.13 A majority of investors (67%), asked for different or additional disclosures to those currently provided by companies; these included requests for less generic and more company specific disclosures. Some of these investors noted that the current requirement to separate identifiable intangible assets from goodwill and their subsequent amortisation sometimes made it harder to understand and assess subsequent performance against management’s objective in purchasing the target. Although no actual proposals for disclosure requirements were put

forward, these investors noted that for business combination transactions they were mainly interested in understanding:

a. Why the company bought the target (access to intellectual property, access to markets or synergies); and
b. Whether the company was succeeding in its original acquisition objectives.

2.14 These investors favoured qualitative and quantitative disclosure that would enable such evaluation during the year of acquisition as well as in future years. It is notable that although IFRS 3 currently requires qualitative disclosure of the primary reasons for the business combination, it does not require that a review against those objectives be provided in the year of acquisition or subsequent years.

2.15 Investors who focused on particularly acquisitive companies stated that a table showing intangible assets split by acquisition, together with a reconciliation of amortisation and impairments during the year would be particularly helpful. Investors asked for three to ten years' comparatives for such reconciliations. Although there may be merit in standard setters addressing the former request, the latter may be better dealt with by use of technological changes in the way companies report their financial statements.

3. Internally Generated Intangible Assets

Should internally generated intangible assets be included in the statement of financial position?

Research and development costs	Development costs only	Never capitalise internally generated intangible assets	Other alternative treatment	Unsure/ No view	Total
4	13	5	2	3	27
15%	48%	19%	7%	11%	100%

How should internally generated intangible assets be treated in the income statement in order to provide useful information to users of financial statements?

Amortise over UEL and assess for impairment?	Do not amortise but assess for impairment	Other alternative treatment	Unsure/ No view	Total
14	5	1	7	27
52%	19%	3%	26%	100%

3.1 We asked investors whether they would capitalise research and development costs or only development costs for internally generated intangible assets such as internally developed software.

3.2 A majority (63%) would capitalise development costs as internally generated intangible assets, but only a small minority (15%) of all investors were prepared to also capitalise the research costs for such assets.

3.3 Those who were amenable to including the research costs did so as they believed that there was “a blurred line” between the research and development phases. These investors believed that this blurred line was exacerbated by the lack of disclosure on the rationale behind the decision to expense or capitalise research and development expenditure. These investors believed that if their proposed capitalisation of research costs does not result in value generation then they can be written off at a later date.

3.4 However, about half of all investors would capitalise only the development costs. These investors were clear that all efforts should be made to identify the differences between the research and development phases and only the latter should be capitalised. These investors favoured management clearly disclosing the basis for such differentiation in the financial statements to the extent that it was material to the future earning potential of the company.

3.5 Just under a fifth (19%) of investors would never capitalise research or development costs. These investors stated that the value and commercial benefit of such internally generated research and development costs was too difficult to verify for outsiders and that current disclosures by management did not provide sufficient information for such verification.

3.6 A small minority (7%) stated that development costs should be included when companies were developing a product capable of being sold to third parties. In the absence of this, they favoured expensing all ongoing research and development costs.

3.7 Investors’ concerns were mainly directed at the fact that the capitalised costs were subject to management judgement, the level of disclosures companies provided meant that investors were unable to independently verify them and their treatment was far from consistent across companies, reducing comparability.

3.8 A number of investors, regardless of their views on the costs to be capitalised, cited the valuation of internally generated assets as being extremely opaque. In particular, investors expressed concern that no arm’s length transactions verified the valuations attributed to the internally generated intangible asset and the disclosures provided by companies in this area were insufficient to explain this.

3.9 Investor views on the treatment of internally generated intangible assets on the income statement were consistent with the views they expressed on the capitalisation of such assets.

3.10 Just over half (52%) of the investors believed that internally generated intangible assets, such as software development costs, should be amortised over their useful economic lives and assessed for impairment on a regular basis. These investors considered the development expense as a true economic expense that requires replacement at a later date. They stated that:

a. They would not expect significant impairments for such assets;
b. Impairments for such assets were indicators of management's stewardship of the company's resources; and
c. Financial statements did not provide the level of granularity to assess the reasonableness of impairments on such assets.

3.11 Just under a fifth (18%) of investors would prefer that such intangible assets were only assessed for impairment on an annual basis. These investors either stated that: costs and useful economic lives for such assets are not verifiable for them from purely looking at the information provided in the financial statements, rendering any amortisation subject to management's judgement; or that there is a high probability of failure of internally generated intangible assets in certain industries (e.g. biotechnology and pharmaceutical companies) and so amortisation is meaningless.

3.12 This view of internally generated intangible assets as a genuine asset was further confirmed by investors when asked about how they treat amortisation on such assets when considering the EPS. Just over half (52%) of the investors never add back amortisation on internally generated intangible assets to the EPS. The main reason being that shareholder capital had been used to generate an asset with a finite useful life the wasting of which must be charged to the relevant revenue. However some noted that such amortisation was too hard to separate out from the disclosures provided by companies.

3.13 A minority (26%), who always or sometimes add back the amortisation on internally generated intangible assets, stated that they focused on the actual spending on such intangible assets. Such investors often cited that they were attempting to value the company and so focused on measurements of performance excluding amortisation charges.

4. Separately Acquired Intangible Assets

Should separately acquired intangible assets be included in the statement of financial position?

Always	Never	Other alternative treatment	Unsure/ No view	Total
24	0	0	3	27
89%	0%	0%	11%	100%

How should separately acquired intangible assets be treated in the income statement in order to provide useful information to users of financial statements?

Amortise over UEL and assess for impairment?	Do not amortise but assess for impairment	Other alternative treatment	Unsure/ No view	Total
15	2	2	8	27
56%	7%	7%	30%	100%

4.1 This was the least controversial type of intangible assets amongst investors. The current IFRS requirements, in particular on capitalisation of such assets, appear to be in line with a majority of investors' expectations.

4.2 The vast majority (89%) of investors stated that such intangible assets should be separately identified on the statement of financial position. They mainly cited the availability of a price paid in the market and a clear useful economic life for the asset as being the main drivers for their view.

4.3 However, some diversity of views appears when considering the income statement treatment of such intangible assets. Over half (56%) of investors agreed that separately acquired intangible assets such as copyright material and wireless spectrum should be amortised over their useful economic lives on the basis that there is a verifiable cost attached to the intangible assets and their useful economic life is determinable.

4.4 A small minority (7%) believed that such intangible assets should only be assessed for impairment on an annual basis. These investors cited a lack of easily accessible information on amortisation at the asset level in the financial statements and stated that impairment tests may result in more useful information being disclosed in the financial statements.

4.5 A further minority (7%) believed that such assets should only be amortised where there is a price and reliably determinable useful economic life, otherwise they preferred such assets to be tested for impairment on an annual basis. These investors particularly raised doubts about the reliability of useful finite lives ascribed to some copyright materials with very long lives.

4.6 These views were also reflected when investors were asked whether they add back amortisation on such intangible assets to earnings per share. A majority (55%) of investors stated that they did not add back amortisation on separately acquired intangible assets as they are wasting in nature with an ascertainable finite life and a verifiable price. By contrast, a minority (19%) of investors stated that they always or sometimes added back amortisation on separately acquired intangible assets. These investors stated that they did this where the finite useful life was not always obvious or determinable from the information in the financial statements.

5. Adequacy of Presentation and Disclosure

5.1 Investors were asked for their views on disclosures of intangible assets as well as any other concerns they had with the financial statements provided. The following is a list of the issues raised by investors:

a. Capitalisation of intangible assets;
b. Disclosures about mergers and acquisitions; and
c. Adequacy of disclosures.

Capitalisation of intangible assets

5.2 Some investors were concerned about the proliferation of intangible assets and the implications for reported capital. As one investor noted, "the fact that more and more companies are resorting to some sort of pre-PPA *[Purchase Price Allocation]* measure of profitability shows that PPA has been a waste of time".

5.3 Another stated that accounting for intangibles and goodwill is currently like a black box from the investor perspective. For example, in the aerospace and defence sector, expenditure on research and development is huge but the companies within that sector interpret IFRS differently. That investor went on to note that there is too much leeway in interpretation of IFRS in this area, as some companies capitalise all expenditure whilst others capitalise none, leading to significant differences on key metrics.

5.4 Other investors put forward concerns with the proliferation of internally generated intangible assets stating that they believed that internally generated intangible assets should only be recognised once the company has identified a selling price i.e. the asset is marketable; up to that point it should be expensed through the income statement.

5.5 By contrast, some investors put forward arguments for recognition of even more intangible assets. These investors noted that knowledge-based companies are often capital light, because their business processes are based on knowledge assets, but have huge market values indicating the non-recognition of some intangible assets. These investors noted that the accounting requirements currently do not reflect the true value of such companies. This view was

articulated by one investor as follows: "Investors are increasingly being forced to focus on cash flows, despite the disadvantages of this approach, as the balance sheet and P&L fail to reflect the realities of trading. As the nature of value creation changes so must financial statements. A separate intangible asset statement (independent of taxation) should be considered."

Disclosures about mergers and acquisitions

5.6 A significant number of investors raised concerns about the disclosures provided by companies on the objectives of business combination transactions, the components purchased and any subsequent impairment. These investors viewed provision of such disclosures as management providing information so as to aid an assessment of whether they are fulfilling their business stewardship responsibilities on behalf of the shareholders and were disappointed by the level of information provided.

5.7 A number of proposals were put forward by investors about additional information they would like to see in an enhanced disclosure on mergers and acquisitions. These are:

a. a list of intangible assets acquired in a business combination transaction;
b. subsequent amortisation and impairment;
c. Weighted Average Cost of Capital (WACC) for the combined group upon acquisition;
d. Qualitative and quantitative disclosure on objective of acquisition – scale, capability, synergy; and
e. A post-acquisition review – reporting back at later date on the achievement or lack thereof of the business combination objectives.

5.8 Other investors proposed a disclosure containing up to 10 year history of acquisitions of intangible assets showing the price paid and subsequent amortisations/impairments by vintages of the acquisition. They believed that such a disclosure would help differentiate the companies that are serial acquirers from those that grow organically.

Adequacy of disclosures

5.9 Most investors were dissatisfied with the current disclosures for intangible assets in general. A number of them noted that, current disclosures in financial statements contain insufficient detail to permit meaningful analysis of either purchased or internally generated intangible assets. These investors often proposed a disclosure setting out a reconciliation of intangible assets that was similar in nature to those for tangible assets. They noted the following items should be included in such a reconciliation:

a. gross spend or capitalised amounts, by the categories of intangible assets (some proposed wasting and organically replaced should be included as categories);
b. method of valuation e.g. hierarchy of valuation and cash flow assumptions used;
c. subsequent amortisation and impairment for each category of intangible assets;
d. a rationale for how the figure included on the statement of financial position originated; and
e. commercial reasons behind the company's acquisitions or development of intangible assets, in particular for asset light companies.

5.10 A number of these investors believed that such disclosure would facilitate analysts adjustments to these numbers e.g. permit them to treat customer lists and brands as goodwill.

5.11 This request appears to be the same as the disclosure requirements in IAS 38 and IFRS 13 *Fair Value Measurement*. It is notable that a number of investors requested a reconciliation for intangible assets that was similar in nature to tangible assets. Preparers following the requirements in IAS 38 should already be providing such a disclosure in their financial statements. The investors' consistent requests indicate either a lack of compliance by preparers or that the disclosures are not providing enough company specific information or presenting that information in a way so as to be useful to these users of financial statements.

5.12 A number of investors also asked for additional disclosures on the impairment tests. These investors noted that accounting for goodwill and intangibles currently creates the risk of artificial value creation and they needed to understand the rationale behind the impairment testing by management to independently verify this was not the case. Suggestions for additional disclosures included:

a. where discounted cash flows (DCF) are used in the impairment test, information on projections and discount rates used should be provided;
b. details of independent valuations used;
c. other assumptions applied to goodwill valuation; and
d. other assumption used in the impairment test.

5.13 Once again, investors appear to be requesting disclosures that are already required by IFRS, in this case IAS 36 *Impairment of Assets,* indicating either a lack of compliance by preparers or that the disclosures are not providing enough company specific information or presenting that information in such a way as to be useful to the users of financial statements.

APPENDIX 1

Research methods

1. The aim of the research was to gauge investor views on the accounting treatment of different classes of intangible assets in the statement of financial position and their amortisation in the income statement. A questionnaire was used for this purpose. It asked investors' views on the accounting treatment of different classes of intangible assets in the financial statements as well as the implications of the amortisation of intangible assets for key performance indicators (KPIs) they used specifically referring to Earnings Per Share (EPS). The questionnaire went on to ask for views on inconsistency of treatment between various types of intangible assets, the relevant disclosures provided in financial statements and whether these were sufficient for investors' purposes.

2. Investors were asked whether they use measures such as EPS. Investors were then asked to identify the types of intangible assets for which they may add back amortisation to the EPS measure. They were given a choice of: intangible assets arising from business combinations; internally generated intangible assets; and separately acquired intangible assets. They were asked to explain the rationale for their choices.

3. A total of 33 investors were approached by research staff and 27 agreed to take part. A range of investors (including fund managers, buy-side equity analysts, and one sell-side analyst) participated in the research. Most of these investors are based in the UK with a minority based in Germany.

4. The questionnaire was sent to the investors to consider. They were given the option of: (1) completing the questionnaire and returning it to the research staff; or (2) taking part in one-to-one interviews with the research staff to discuss their views. All bar three took up the second option.

5. Research staff analysed the result to understand the range and diversity of investor views in this area. The nature of this research topic is such that it is only attractive to a subset of investors. As a result, it is difficult to draw definitive conclusions that can be generalised to the wider population of investors whose focus may not be on the research topic.

Timing of the research

6. The research period spanned from April 2013 to January 2014.

6. Contact Details

Comments should be sent to:

Anthony Appleton
Director, Accounting & Reporting Policy
a.appleton@frc.org.uk

Seema Jamil-O'Neill
Project Director, Accounting & Reporting Policy
s.jamiloneill@frc.org.uk

Financial Reporting Council
5th Floor, Aldwych House
71-91 Aldwych
London WC2B 4HN

+44 (0)20 7492 2300

www.frc.org.uk