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29 April 2019

Ref: AC/FRC

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Dear Mr Lennard

Discussion Paper - Business Reporting of Intangibles: Realistic proposals

EY welcomes the opportunity to comment on Discussion Paper - *Business Reporting of Intangibles: Realistic Proposals* (Discussion Paper) issued by the Financial Reporting Council (FRC).

We support the Discussion Paper's conclusion that radical change in accounting for intangible assets is not needed, but that there is scope for improvement in narrative reporting on intangibles (as defined in the Discussion Paper), given their importance in creation of value. However, this is only part of a much wider challenge about the future of financial reporting and, in particular, measuring and communicating the creation of long-term value.

The Embankment Project for Inclusive Capitalism (EPIC) was established in 2015 by the Coalition for Inclusive Capitalism and EY with the goal of identifying and creating new metrics to demonstrate long-term value to financial markets. Since its launch EY has been proactive in sharing EPIC's various milestones with the FRC and Financial Reporting Lab, reflecting the participation of various FRC committee members in the initiative.

The project was undertaken in collaboration with 31 companies, asset managers and asset owners (with approximately USD 30 trillion of assets under management) and academics. Its recommendations, issued in 2018, set out a Long Term Value Framework and standardised metrics which attracted consensus in four key areas - talent, innovation and consumer trends, society and the environment, and governance. Some of the metrics developed are based on those already reported by leading companies. The aim is that the wider use of standardised metrics will enable comparability across companies and, through accompanying narrative, assist in effective communication. The report is available on . The project's findings are an important first step, with further work needed to apply the results and to define additional metrics in the value areas considered. It is hoped that companies will apply this framework to help them identify the factors significantly affecting long-term value and develop appropriate metrics. There may be opportunities for further collaborations to take this work forward. EY believes that the FRC's objectives in improving narrative reporting on intangibles overlap with those of EPIC.

There is also considerable overlap of the FRC's objectives with both the FRC's project on the *Future of Corporate Reporting, October 2018,* and Sir Donald Brydon's *Independent Review Into The Quality and Effectiveness of Audit, Call for Views, April 2019.* The latter will seek to establish the needs of users of corporate reporting and the quality, effectiveness and scope of audit. Again, it would be optimal for these various exercises to be pursued in a coordinated manner.

The attached appendix contains our responses to the questions included in the Discussion Paper.

If you have any matters arising concerning the content of our response, please contact Tony Clifford on 0207 951 2250.

Yours sincerely,

Tony Clifford
Partner - UK Head of the Financial Reporting Group
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Appendix: Responses to FRC questions

Discussion Paper - Business Reporting of Intangibles: Realistic Proposals

01. Do you agree that it is important to improve the business reporting of intangibles?

Yes. Intangibles are not often recognised in financial statements, but are important to the creation of long- term value and consequently to an understanding of the performance, position, stewardship and development of businesses. However, EY believes that improvements in business reporting of intangibles should focus on the disclosure of intangibles rather than a change to the recognition principles. Better communication about intangibles represents only part of a wider challenge for the future of financial reporting: how to measure and communicate the creation of long-term value. As set out in our covering letter, the objectives of the FRC overlap with those of the Embankment Project for Inclusive Capitalism (EPIC).

Q2. Do you agree that an intangible should be recognised at cost under the two conditions set out above in (i)?

No. The Discussion Paper (DP) does not set out the case for the first of the two criteria in paragraph 2.14 (i), that the amounts capitalised should not exceed the initially estimated cost. EY is not convinced that this will enhance the reliability or relevance of financial reporting. There is also a danger that the first criterion will provide incentives for companies initially to overestimate the cost of developing the intangible asset. Generally, the existing IFRS requirement to test an intangible under development annually for impairment (and to meet strict criteria for capitalisation) means that costs that are irrecoverable should be written off. It is not clear why further increases in cost should not qualify for capitalisation, if recoverable. Sometimes the scope of a development project may change while the development is being carried out, but the changes may be considered value-enhancing.

We agree that the second criterion set out in paragraph 2.14 (i) is relevant, but an assessment of "how the intangible assets will generate probable future economic benefits" is already one of the criteria for capitalisation of internally developed intangible assets required by paragraph 57 of IAS 38. This assessment would also be required to perform the mandatory impairment review required for intangible assets under development.

03. Do you agree with the assumptions the paper makes regarding measurement uncertainty of intangibles?

At present, very few intangibles qualify to be carried at fair value. EY considers that this situation is appropriate.

In particular, the inherent uncertainty of the measurement of fair value of intangible assets calls into question whether it could provide a representationally faithful depiction for internally developed intangible assets. In addition, there is the added cost and effort required of entities (and their auditors) in revaluing the intangible asset at each period end (and auditing the valuation). Cost less impairment and amortisation remains the most appropriate measurement basis.

Entities routinely measure intangible assets acquired in a business combination initially at fair value. However, we note that the DP deliberately scopes out of its review the accounting for goodwill, to avoid duplication of efforts with an IASB Discussion Paper expected to be issued later in 2019, and recent research activities completed by EFRAG. A discussion about intangibles acquired in a business combination cannot be conducted without also considering the accounting for goodwill, including what should be capitalised separately and whether it should be amortised.

4. Do you agree that existing accounting standards should be revisited with the aim of improving the accounting for intangibles?

No, although there may be some merit in additional guidance on what constitutes directly attributable costs.

EY agrees with the basic tenet of the DP that a radical change to current accounting for intangibles is not needed. IAS 38 currently includes adequate guidance for the recognition and measurement of intangible assets and, in our experience, is generally well understood,

However, while paragraphs 65 to 67 of IAS 38 set out what costs should and should not be capitalised, there remains area for judgement on whether certain costs meet the criteria to qualify for capitalisation. In particular, issues may arise in determining what overheads may be directly attributed to preparing the asset for use, or identifying inefficiencies (where projects overrun budget). These issues are not restricted to capitalisation of intangible assets, as illustrated by the proposed amendments to IAS 37 'Onerous Contracts - Cost of fulfilling a contract' (ED/2018/2), issued by the IASB in December 2018.

5. Do you agree with the above proposals relating to expenditure on intangibles? EY

has reservations over the specific disclosures proposed, as explained below.

However, as a general principle, we would support proposals that encourage wider adoption by companies of disclosures of metrics concerning intangibles, as part of their narrative reporting. This area has already been the subject of other initiatives, including EPIC (see our covering letter) and any initiatives will be most effective if building on this work.

As an example, the EPIC report proposes that metrics and the associated narratives for human capital should be based on five dimensions:

1. Workforce costs (e.g., the total of salaries, bonuses and pensions costs).

2. Attraction, recruitment and turnover (e.g., annual turnover, by region, age and gender and the percentage of turnover that is voluntary, including amongst high performers).

3. Workforce composition and diversity (e.g., gender, orientation etc, for the workforce and top management, and details of modes of employment, such as full-time versus part-time).

4. Training, learning and development (e.g., annual training hours per employee and cost per hour, plus measures of the effectiveness and return on investment).

5. Engagement and wellbeing (e.g., engagement index scores, absenteeism statistics and mental wellbeing rates, such as the percentage days lost, by department).

Also, before introducing new disclosures of the type proposed by the FRC, it would be important to assess whether there is demand from investors and other stakeholders. IAS 38.126 already requires disclosure of the R&D expense that has been recognised as an expense in the year. IAS 38.128 encourages but does not require a brief description of significant intangible assets controlled by the entity but not recognised as assets.

We agree with the concerns expressed in paragraph 3.8 of the DP that such information (absent a robust accounting framework) would lack comparability. Hence, EPIC seeks to establish a framework to establish common metrics and narratives.

As regards the DP's example disclosure in paragraphs 3.9 and 3.10, it would often be difficult to distinguish between and measure current period expenditure and future-oriented expenditure, especially as much of the most effective training in many organisations occurs through "on-the-job" training rather than in a classroom. Meanwhile, a roll forward of training expenditure implies spurious accuracy as to the measurement of the various components (since internal accounting systems may not be set up to capture such costs or identify inefficiencies in spend) and provides only limited insight on the related benefits. A high or low level of staff training itself (an input measure), on its own, has little informational value without understanding issues such as who and what is being trained, the related benefits or outcomes, how effectiveness of training is monitored, or the level of staff turnover.

06. Do you agree with the proposals aimed at improving the quality of information on recognised and unrecognised intangibles in narrative reporting?

EY supports initiatives to improve the quality of information on recognised and unrecognised intangibles in narrative reporting. But reporting of intangibles is only one element of a wider challenge about the reporting of long-term value creation (see our covering letter).

We agree that any initiatives that include the reporting of intangibles should focus on those intangibles most relevant to the business model (described in paragraph 7A.15 of the FRC Guidance on the Strategic Report as 'how the company generates and preserves value over the long term') and strategy. Paragraph 7A.16 of the FRC Guidance on the Strategic Report further notes that understanding the key resources and relationships supporting the generation and preservation of value is critical to understanding the business model, giving examples of many intangibles that could be key sources of value.

Therefore, enhanced reporting on intangibles would be consistent with existing statutory requirements for companies to provide a fair review of the company's business (and for certain companies to prepare a non-financial information statement). Better information on intangibles would enhance reporting in the business review on how directors have performed their duty under section 172 to promote the long-term success of the company, having regard to the interests of wider stakeholders. In our view, it would be important to embed enhanced reporting on intangibles within the existing framework of narrative reporting rather than as an add-on.

We note that key non-financial performance indicators are already required to be disclosed under s414C(4). Indeed, it is not uncommon to see measures such as employee turnover, employee survey scores or customer satisfaction (such as net promoter score) or information on product pipeline to be presented, although these metrics may be difficult to compare across companies.

We support the use of metrics to enhance the information presented but agree that a "fair value" is unlikely to be useful, given the difficulties over reliability of measurement particularly for internally developed intangibles. Companies should consider carefully which metrics are relevant to their business. In addition to a clear definition (adequate to understand the methodology behind the metric) and the narratives of the factors causing change in the metrics and a comparison with management targets (as suggested in paragraphs 4.14 and 4.16 of the DP), we believe that the accompanying narrative discussion should explain why the metric has been chosen and link it to the business model and strategy.

Where similar metrics are commonly used in an industry, there is merit in standardisation and we support initiatives to develop standardised metrics that achieve consensus and if widely adopted, would improve comparability. The challenge here will be standardising the metrics used, while remaining relevant to a company's circumstances. Without industry standardisation their usefulness would be limited, but a company may feel it needs to present supplementary information with an explanation.

It would also be helpful to develop characteristics of metrics that provide relevant and reliable information to investors. Much useful work exists on this already. For example, the FRC's Guidance on the Strategic Report addresses KPIs and alternative performance measures, and the FRC Lab published a report 'Performance Metrics - Principles and Practice' in November 2018 which has outlined some useful principles to apply in this area.

07. What are your views about how the various participants involved in business reporting could or should contribute to the implementation of the proposals made in the paper?

EY believes there is value for preparers and investors to work together to improve the business reporting of intangibles. Many companies do refer to intangibles in narrative reporting and it is not uncommon for companies to present measures such as employee or customer satisfaction or safety incidents or environmental information. However, if companies are not reporting non-financial KPIs or those reported have limited informational value for investors, it would be important to understand why. This is an area where collaborative input from stakeholders (preparers, investors and regulators) would be important.

The driver behind EPIC was that there was no consensus over what metrics on intangibles and shareholder value should be given, or how these should be measured. This meant it was difficult for companies to effectively communicate factors affecting long-term value. EPIC has developed standardised metrics in certain areas and a Long Term Value Framework for disclosure of metrics on intangibles which could be applied by companies. The project recognised that new metrics will only be useful if companies, investors and asset owners buy into them, and emphasised the importance of consensus. However, EPIC's work is acknowledged as an important first step rather than the end of the process, with the hope that the project's findings will encourage wider adoption.

Other initiatives, such as the Task Force on Climate-related Financial Disclosures have developed disclosure recommendations covering governance, strategy, risk management and metrics, with the aim of wide adoption.

As noted in our response to Question 5, enhanced disclosures of intangibles do fit well within the existing business review required in the strategic report. There have been various initiatives and related frameworks on the reporting of intangibles, which create their own challenges. Another challenge is for companies to determine what information is key to the business review (application of EPIC's Long Term Value Framework may provide a basis for this) and what information is relevant to stakeholders but may be more appropriately communicated outside the annual report. Further collaboration between preparers and investors, which may involve experimentation and working through of the practical realities of disclosure, might help to broaden best practice in these areas.

We believe accounting standard setters (and regulators) have a role to play in developing guidance and expectations of quality disclosures, to encourage wider adoption. For example, the FCA has raised the profile of climate-related disclosures with its October 2018 Discussion Paper 'Climate Change and Green Finance' (DP 18/18) and the European Securities and Markets Authority's Alternative Performance Measures Guidelines (and their enforcement) have improved significantly the quality of reporting in this area. However, it can genuinely take time for consensus best practice reporting to develop, particularly over what disclosures of intangibles are relevant to a company's business and of interest to investors. The quality of strategic reports has improved over time, with additional guidance and regulatory enforcement. This is also likely to be the case with enhanced business reporting of intangibles.

8. Do you use additional information other than the financial statements when assessing and valuing intangibles? If so, can you please specify what additional information you use.

We believe that users of financial statements are best placed to respond to this question.

9. Do you have any suggestions, other than those put forward in this paper, as to how improving the business reporting of intangibles might be achieved?

We believe that the work of EPIC (see our covering letter), while only a first step, has made a significant contribution to the reporting of intangibles.