Corporate Reporting Committee

30 April 2019

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Re: Response to the FRC's Business Reporting of Intangibles Proposals

Dear Mr. Lennard and Members of the Council,

Please find attached a memorandum outlining our response to the FRC's "Business Reporting of Intangibles: Realistic Proposals", which we submit on behalf of the European Accounting Association's Corporate Reporting Committee ("CRC"). Our response reflects the views of the CRC members, not necessarily those of the entire membership of the EAA.

Overall, we consider that the implementation of the FRC's proposals would lead to significant – and very much needed – strides in the reporting of intangibles. We are particularly in favor of the expanded income statement designations of intangibles-related expenditures that are current period versus future-oriented. Together with the proposed footnote disclosures, this approach could effectively be an improvement to the current reporting regime. Our attached memo discusses this and other aspects of the FRC's proposal at greater length.

We hope that you find our response useful in your deliberations.

Sincerely,

The Corporate Reporting Committee of the European Accounting Association

Response of the Corporate Reporting Committee of the European Accounting Association to the FRC's "Business Reporting of Intangibles: Realist Proposals"

Question 1
Do you agree that it is important to improve the business reporting of intangibles?

We indeed agree that the better reporting of intangibles is one of several areas where performance reporting needs to be improved However, we would also like to see advances in other areas such as the separation of performance relating to operating versus financing activities, and the identification of one-time/transitory items from more sustainable income components.

Question 2
Do you agree that an intangible should be recognised at cost under the two conditions set out above in (i)?

We tend to agree with the FRC's position related to the (non-) recognition of intangibles, although there are different views within our committee about the second condition. Some members consider it overly difficult relative to the requirement for tangible assets, while others agree that this is a necessary condition due to the high level of uncertainty about future cash flows. In any case, we do not agree with the assertion that reporting intangible assets at cost will not provide relevant information (paragraph 2.14 of the FRC proposal).

We recognize that there is currently some inconsistency between the balance sheet treatment of expenditures on externally purchased versus internally developed intangibles, which leads to income statement effects and obscures the comparability of key performance measures across entities. It also leads to a mismatching of revenues and the expenses that were incurred to generate them. With respect to the latter, a survey of CFOs reveals that 92% of respondents consider that accounting policies contributing most to high quality earnings are those that *do match* expenses with revenues ((Dichev, Graham, Harvey and Rajgopal (2013))).

We respectfully refer the FRC to (Lev (2018))'s proposals towards the capitalization of expenditures on intangibles that, leaving aside the request of "legal ownership", is rather consistent with existing standards (see his discussion beginning on page 26), and explicitly addresses the usual concerns raised regarding the uncertainty of the intangibles' future benefits (page 36 and elsewhere). We do not repeat Lev's arguments in detail here, but instead refer the reader to the original document.

We believe that if the costs incurred on the development of an intangible asset can be estimated at the time that the project is undertaken, an intangible asset should be recognized, as long as the economic benefits can be reasonably specified when the costs are incurred. In other words, we would like to see intangible assets recognized at cost *independently* of whether they are purchased externally or internally developed, provided there is some evidence of their ability to generate benefits in the future. As educators, we regularly witness the confusion that the current inconsistent treatment of intangibles such as brand names creates on the part of accounting neophytes (from undergraduates through to executive level students). From the perspective of business economics and with the stated goal of providing relevant (and comparable) information, it is not possible to satisfactorily justify the current approach to accounting for intangibles to an educated and sophisticated group of non-accountants. Furthermore, with the exception of the request of legal ownership, as Lev (2018) argues, the proposed change to capitalization at cost does not require a revision to the existing Conceptual Framework.

Question 3
Do you agree with the assumptions the paper makes regarding measurement uncertainty of intangibles?

Yes, we agree that for many intangibles measurement uncertainty can be quite high. In particular, measurement at fair value is probably fraught with an unacceptable level of uncertainty such that in many cases fair value valuations may not lead to the provision of a “true and fair view” of the firm’s financial position. Notwithstanding the uncertainties associated with fair value estimates, however, we still consider the cost approach to be sufficiently reliable for both internally-generated and externally purchased intangibles to warrant adoption. It is a matter of further research to document whether the uncertainties associated with internally produced intangibles are really greater than those associated with internally produced tangible assets or externally purchased intangibles so as to justify the current inconsistency in their treatment.

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

We do consider it necessary to eventually revisit the existing accounting standards in order to ensure an improved recognition of intangibles, which are, after all, the most significant assets in the economy today. As explained above, however, we do not consider such an overhaul to be necessary in order for expenditures on intangibles to begin to be included on the balance sheet. Thus, we support your statement that IAS 38 should be reviewed to evaluate whether its requirements conform with, or are going beyond, the criteria considered by the Conceptual Framework.

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

Yes, we strongly agree that the income statement segregation of intangibles-related expenses as between those that are related to the current period versus those that are future-oriented is an extremely useful and important innovation to the existing financial reporting model.

This segregation would enable financial statement users to develop their own “pro forma” measures of the firm’s *current period* earnings (i.e., by excluding the future-oriented expenditures on intangibles) in order to create “apples-to-apples” comparisons of the current period financial performance across firms and for the same firm across time (i.e., a most basic and fundamental use of the financial statements).

While we acknowledge the subjectivity of the segregation of the expenditures into a current versus future period orientation, we do not consider this to be a barrier to the implementation of the proposed enhanced disclosure. Rather, we consider management’s footnote commentary related to their reasoning behind the segregations to be an essential part of the proposed new income statement presentation format. This additional disclosure will enable financial statement users to better understand the role of intangibles in management’s overall strategy for the firm, as well as to infer management’s philosophy related to intangibles investments. Contrary to the concerns raised that this might lead to increased earnings management, we expect that some significant value-destroying “real activities” earnings management (i.e., cutting R&D or other immediately expensed expenditures on intangibles in the current period in order to hit an earnings target) will be curtailed as the proposed income statement segregation would shine a greater light on management’s short-term versus long-term thinking in this regard.

We also strongly support the supplemental footnote disclosures proposed in the FRC proposal’s paragraph 3.10, and indeed we view these as a reasonable compromise to full on-balance-sheet recognition of the intangibles-related expenditures. While supplemental footnote disclosures are not viewed by market participants as equivalent to the same or similar items that are recognized on the face of the financial statements (e.g., (Barth, Clinch and Shibano (2003)); (Ahmed, Kilic and Lobo (2006)); (Israeli (2015)); amongst many other studies), five decades of capital markets research in accounting establishes that market participants are nevertheless generally attentive to information disclosed in financial statements and their footnotes ((Kothari (2001))). Ultimately, the informativeness of the proposed disclosures in paragraph 3.10, and thus their implied reliability and candidacy for eventual full recognition, is a question not only of conceptual consistency vis-à-vis tangible assets and externally purchased intangibles, but also of an empirical nature. Notably, once such disclosures are accepted and become prevalent, their relevance to financial statement users can be validated (or refuted) via analyst and investor surveys and/or through empirical archival research. Indeed, there is a strong history of accounting research contributing to the standard-setting process by establishing the value-relevance of such controversial items that are first recognized as footnote disclosures before eventually gaining full recognition in the statements.[1] The proposed disclosures related to intangibles could reasonably be expected to pass through a similar period of preparer and user acceptance, large sample validation, and eventual full financial statement recognition, even though the "immediate" passage to full recognition would be preferable for the urgency of addressing the lack of information on intangibles (see above our answer to question 2).

Despite our previously stated preference in favor of the proposed extended footnote disclosures, we would be remiss not to point out the existence of another strand of academic literature that focuses on the potential proprietary costs of disclosure and, notably, that questions the adequacy of mandated disclosure. Koh and Reeb (2015) report that a significant number of firms fail to report R&D expenditures even when there is evidence of their undertaking R&D activity. The authors reasonably conjecture that such non-disclosure reflects proprietary costs.
By implication, mandated disclosure recommendations may be ignoring the potentially significant proprietary costs associated with disclosure. Furthermore, such mandates ignore the significant incentives that exist for firms to voluntarily disclose information regarding their unrecognized intangibles, a market-based, rather than regulatory-enforced, (partial) solution that is quite prevalent in many affected industries (e.g., biotech or pharmaceuticals).

In summary, although we consider the income statement segregation of intangibles expenses into current and future-oriented line items, together with supporting footnote disclosures of managers' rationale for the income statement segregation process and the proposed "asset" continuity schedule outlined in paragraph 3.10, to be a good first step towards the improvement of intangibles reporting, we would like to see further research on the user-perceived relevance and reliability of such disclosures. Furthermore, we consider the inclusion of these items within the financial statements (i.e., the segregation of the intangibles-related expenses on the income statement and the associated disclosures provided in the footnotes thereto) to be essential as the auditor's attestation on this information will be important to establish its validity and thus utility to the firm's external constituents.

Question 6
Do you agree with the proposals aimed at improving the quality of information on recognised and unrecognised intangibles in narrative reporting?

We agree with the general notion that an improvement to the narrative reporting related to recognized and unrecognized intangibles is important and highly desirable. However, we consider some of the suggested disclosures to be somewhat unrealistic in terms of their likely acceptance by the preparer community. For example, paragraph 4.16 proposes that management provide its views of "how the reported metrics compare with management's realistic targets" (page 19). This proposal actually goes beyond what is required in relation to *earnings* as

[1] See, e.g., Barth, M. E., W. H. Beaver, and W. R. Landsman, 1996, Value-relevance of banks' fair value disclosures under sfas no. 107, *The Accounting Review* 71, 513-537. in the context of disclosures of financial instruments' fair values and Aboody, D., M. E. Barth, and R. Kasznik, 2004, Sfas no. 123 stock-based compensation expense and equity market values, ibid.79, 251-275. in relation to employee stock option expenses, amongst many others.

managers are generally neither required to present earnings forecasts, nor therefore explicit reconciliations to earnings "misses", despite the overwhelming importance and disproportionate amount of focus on this particular financial performance measure. Thus, by asking for such a high standard of disclosure in relation to other performance metrics, we fear that the FRC's proposal may lead to a significant general loss of support on the part of preparers, a loss of support that could lead to too few gains being made towards seeing the much-coveted income statement and footnote disclosures discussed earlier.

Furthermore, we recognize that the specification of narrative and/or non-financial "hard" disclosure requirements is difficult given the extreme diversity in the relevance of alternative measures to different firms or in different contexts and industries. Rather than try to "reinvent the wheel" in this regard, we would suggest perhaps referring to reporting frameworks and KPIs that have been developed by other bodies, such as the industry-based KPIs suggested by the World Intellectual Capital Initiative-WICI Global Network, or more generally the framework suggested by the IIRC ((International Integrated Reporting Council (IIRC) (2013))).

In order to be most useful, it would be important that the intangibles information be comparable. Perhaps a way forward in this regard would be to follow the "inverted pyramid approach" suggested by WICI[2],which includes three levels of disclosure based upon increasing specificity. The first level offers a minimum common denominator – i.e., a few intangibles-related monetary and non-monetary indicators and metrics that could be applied by all companies (e.g. R&D expenses, training expenditures, customer satisfaction). The second level of information provision involves industry-specific indicators and disclosures that can be selected from a provided set of metrics and KPIs (e.g., as suggested by WICI, or the SASB for sustainability). And the third level of disclosures is one for which companies are encouraged to complement the first two levels by including their own intangibles-related metrics and KPIs on a voluntary basis. Following from such a model, we expect that, with the increased emphasis on intangibles disclosures, industry norms and "best practices" would rapidly evolve that could, perhaps, eventually become codified.

Question 7
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?

We expect that obtaining financial statement preparer buy-in for any proposed extensions to existing intangibles-related disclosures will be difficult, but it is obviously also essential to making forward progress in intangibles' reporting. In this regard, we believe that as most of the useful metrics are industry-specific, it will be important to involve industry associations.

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[2] See Chapter 4 of the WICI Intangibles Reporting Framework (http://www.wici-global.com/wp-content/uploads/2016/09/WICI-Intangibles-Reporting-Framework_ver-1.0.pdf)

For non-financial indicators that are central to the narrative side of reporting on intangibles, it would be important also to involve the established global organizations operating in this field (e.g. WICI, IIRC).

Finally, in order for these expanded disclosures to have credibility with financial report users and thus to gain rapid acceptance as an important source of information related to the firm's intangibles investments and management, we consider that some form of attestation on the disclosures would be invaluable. In this regard, the involvement of the traditional external audit firms and the relevant national professional associations would be indispensable, as would consideration of the discussions about Extended External Reporting (EER) Assurance and the IAASB's initiative related thereto.

Question 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 refer to externally provided estimates of brand values such as those listed by Interbrand (https://www.interbrand.com/best-brands/best-global-brands/2018/ranking/) as well as other firm-provided voluntary disclosures (i.e., outside of the financial statements) related to their R&D activities (e.g., potential size of markets being targeted by new research projects; research progress as tracked using scientific indicators and/or advancements through the regulatory process); marketing-related indicators such as page views, subscriber base statistics, and other indicators of "reach"; organizational-related indicators such as training, quality targets, productivity, personnel features, employee engagement and satisfaction; ESG-related disclosures – including those mandated by the EU Directive that has recently become effective – particularly given that these have been shown to impact the firm's relations with consumers, employees, and thus ultimately the capital markets; new or evolving strategic alliances with other entities; discussions regarding the firm's strategy as this impacts the value of their existing intangibles and the likelihood of the firm generating new and valuable additional intangibles; information related to customer and supplier markets as well as reputation and customer satisfaction and loyalty.

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?

All of our suggestions have been included in the responses above.

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