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Dear Mr Lennard

Business Reporting of Intangibles: Realistic Proposals – Discussion Paper

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the Financial Reporting Council's (FRC) discussion paper 'Business Reporting of Intangibles: Realistic Proposals'.

Grant Thornton UK LLP is a leading financial and business adviser with offices in 25 locations nationwide and provides services to over 40,000 privately held businesses, public interest entities and individuals. The Grant Thornton global organisation is one of the world's leading organisations of independent assurance, tax and advisory firms. Grant Thornton member firms operate in over 130 countries.

We support the overall proposals as set out in the discussion paper and believe that companies should be encouraged to improve their business reporting of intangibles, particularly in cases where the application of the IASB Conceptual Framework and accounting standards would not permit the recognition of an intangible asset.

However, we feel that requirements already broadly exist to support the business reporting of intangibles. It is therefore unclear as to why the existing requirements are apparently not at present sufficient to encourage this disclosure, particularly in the narrative sections of the financial statements. We would therefore encourage an FRC Financial Reporting Lab study into how the existing requirements can be used to encourage best practice in the reporting of intangibles.

For example, the strategic report requirements of the Companies Act 2006 include a fair review of the company's business, and for quoted companies the strategic report must contain a description of the company's business model. In addition, the directors of companies that apply the UK Corporate Governance Code should state in the annual report that they consider the annual report and accounts, taken as a whole, are fair, balanced and understandable, and provide the information necessary for shareholders to assess the company's position, performance, business model and strategy. Companies may also disclose their business model as best practice even if not required by regulation. Whilst these requirements do not go so far as to specify that a discussion of unrecognised intangibles is required, investors have previously indicated that they expect to see this as part of the business model disclosure and are interested in how companies generate economic value.

As well as regulation there is also relevant guidance in the FRC's Guidance on the Strategic Report and FRC Lab studies have also touched on this subject.

The recognition and measurement of intangible assets is a complex area of accounting. The recognition criteria for internally generated intangible assets is deliberately stringent and we would not want this to be relaxed, at least in the short term. We would however encourage further research into the benefits of increasing the extent to which intangibles are recognised as assets, analysis as to which intangibles are reflected in the difference between a company's market value and its balance sheet value and how realistic it is that such intangibles, even if identified can be valued. However, we do recognise that as a result there is a current mismatch between the treatment of certain intangibles that are recognised as assets as a result of a business combination, for example, but which would not qualify for recognition where the intangible has been internally generated. Better disclosure in relation to unrecognised intangibles might therefore go some way to bridge this gap.

We would therefore encourage improved disclosure, where possible, on the expenditure on intangibles, however we note that challenges exist around measuring intangibles at cost, which could have an impact on the ability to make meaningful disclosures and make comparisons between companies. Where disclosure is possible, this information could be useful to investors, particularly when differentiating between companies in the same line of business having a different attitude to spending on intangibles. However, we would caution specific disclosures on the face of the profit and loss as there is a danger that companies could use this disclosure to present results in a more favourable light. As such the disclosure of intangible expenditure in the notes to the financial statements would be our preferred approach.

In respect of narrative reporting, and as noted above there are already various requirements and sources of guidance regarding narrative disclosures, which encompass unrecognised intangibles.

The discussion paper also refers to the existence of the view that there is an increasing divergence between the net asset value of a business and that of its market value. It would be interesting to understand, possibly through some research, what the reasons are for the apparent growing difference between the market capitalisation and the balance sheet value of a business, particularly as unrecognised value within a business has always existed.

Finally, improved disclosure in a particular area of reporting often develops over time. This is achieved through peer pressure, publication of best practice examples, discussion with investors, FRC focus, FRC Lab studies, and periodic updates to guidance such as that relating to the strategic report.

We set out our response to each of the questions raised in the attached Appendix.

If you have any questions on our response, or wish us to amplify our comments, please contact Jake Green (telephone: 0207 728 2793, email jake.green@uk.gt.com).

Yours sincerely

Jake Green

Technical Partner

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Appendix 1 - Business Reporting of Intangibles

Question 1

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

In principle we agree that there is scope for improvement in the reporting of intangibles. We understand that there is evidence that investors are primarily interested in understanding how companies generate economic value.

The FRC lab report: Business Model Reporting (October 2016 – page 13) states:

'Investors also expect the disclosure to highlight any key assets and liabilities that support economic value generation. For instance, they expect the disclosure to clearly describe any intangible assets (on or off-balance sheet) that are an essential element of the business model. Further, the related research and development or maintenance spend is also important as investors want to understand how essential assets are maintained or enhanced.'

Whilst business model reporting is a specific requirement of the strategic report for quoted companies and those companies that are required to give disclosure of non-financial and diversity information, other companies, including AIM, sometimes provide that information voluntarily.

The recognition and measurement of intangible assets is a complex area of accounting. This is in part due to the lack of physical substance, the frequent lack of a market in which intangible assets are bought and sold, their uniqueness and that often their value is primarily to the party that has developed them.

The nature of an intangible asset is such that due to the lack of physical substance it can take many forms. The range of what different businesses might consider to represent an intangible or intangible asset is wide which therefore adds to the complexity. What one business may view as being an intangible that has value may not be the same for another business.

In our view the recognition criteria for internally generated intangible assets is deliberately stringent and we would not want this to be relaxed. To do this would require reconsideration of the IASB Conceptual Framework and consultation on IAS 38 Intangible Assets. In addition, there are certain internally generated intangibles that are specifically prohibited from being recognised in accounting standards (IAS 38.63).

However, we do recognise that as a result there is a potential mismatch between the treatment of certain intangibles that are recognised as assets as a result of a business combination, for example, but which would not qualify for recognition where the intangible has been internally generated. Better disclosure in relation to unrecognised intangibles might therefore go some way to bridge this gap.

In the absence of changes to the recognition criteria for intangibles, the most obvious way to improve reporting is therefore to encourage better disclosure around the expenditure on intangibles as well as explaining the nature and importance of intangibles that exist within a business and which contribute to the generation of economic value.

However, we are unclear as to why the existing requirements and sources of guidance that support disclosure of intangibles are not sufficient. We discuss this point in question 6.

Question 2

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

We broadly agree with the analysis set out in section 2 of the discussion paper. Within the constraints of the IASB Conceptual Framework and IAS 38, it is unlikely that the number of intangibles that would qualify for recognition at the present time could be increased.

Meeting the definition of an asset

As indicated by the analysis set out in the discussion paper, the recognition of an intangible as an asset must at present meet a very high hurdle in order to reflect the principles set out in the Conceptual Framework and the specific requirements of IAS 38.

In the first instance the intangible must meet the definition of an asset and in many cases will fail at this hurdle, as it does not meet criteria such as being 'identifiable', 'separable', 'arising from contractual or other legal rights' or an 'economic resource controlled by the entity' etc. Whilst an intangible item may meet at least one of these criteria, few are likely to satisfy all the relevant conditions.

Being capable of recognition

Even where an intangible does meet the definition of an asset, it still has to be capable of being recognised in a way that is useful and relevant and gives a faithful representation of the asset. The ways in which an intangible can be measured are cost or using a valuation method. However, in the case of cost, in some cases there may be no identifiable cost to recognise even if in principle an intangible asset could be said to exist.

As the Conceptual Framework does not distinguish between different types of assets, any change to the recognition criteria for assets could have a consequential effect on a wider range of assets than simply intangibles.

Recognition at cost

IAS 38 notes that the cost of an internally generated intangible asset is the sum of the expenditure incurred from the date when the intangible asset first meets the recognition criteria. Recognition requires that it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity and that the cost of the asset can be measured reliably.

We note that the discussion paper proposes that in order for an intangible asset to be recognised at cost, it is necessary that:

- the costs to be incurred on development of an intangible asset can be estimated at the time when a project to develop an intangible is undertaken. The amount capitalised should not exceed these estimated costs in view of the difficulty of establishing the future economic benefits; and
- the economic benefits to be derived from the intangible can be specified when the costs are first incurred, and hence a relevant method of amortisation or monitoring for impairment can be established.

These requirements appear to be more stringent than those outlined in IAS 38. We are not aware, in the absence of additional requirements in relation to cost, of there being evidence that intangible assets are being recognised inappropriately. We would therefore argue that these additional requirements are unnecessary.

Recognition at fair value

We agree with the difficulties that are faced in valuing many intangible assets at fair value. However current standards require intangible assets to be initially measured at cost, which itself presents challenges. In other words, the choice of fair value is only an option following initial recognition.

Recognition of an intangible asset and goodwill as part of a business combination

We note that the paper refers to the separate recognition of intangible assets as part of a business combination. This treatment typically results in the recognition of some assets as intangible assets subject to amortisation and other intangible assets subsumed within goodwill for which impairment reviews are carried out. We are aware that there has been some discussion as to whether the amortisation of goodwill should be reintroduced or whether the composition of any goodwill should be more clearly explained. On the other hand one could argue that it should be possible to reconcile any excess of the price paid for a business and its fair value to a range of intangible assets such that there is no need to recognise goodwill at all. Alternatively, there may be a case for simply recognising goodwill in a business combination with no recognition of intangible assets. This is an area in which the FRC could sponsor further research.

Understanding the difference between the net asset value of a business and its market value

The discussion paper also refers to the existence of the view that there is an increasing divergence between the net asset value of a business and that of its market value. It would be interesting to understand, again possibly through some research, what the reasons are for the apparent growing difference between the market capitalisation and the balance sheet value of a business. How much of that difference, for example, is attributable to businesses where technology, knowledge and rapid innovation are key features and those arguably more traditional businesses such as manufacturing which have been impacted less by technology? Intangibles, such as brands, have always existed so there has always been a divergence between a company's balance sheet value and its market value. Has the 'issue' therefore become more marked as a result of technological advancement and the ways in which businesses operate and generate value, and the fact that accounting has not fully kept up with these changes?

Question 3

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

Yes.

We agree that there are intangibles that even if they were to meet the definition of an asset would give rise to measurement uncertainty in respect of cost and/or fair value.

However, in some cases an intangible clearly exists within a business (a brand or customer list, for example) yet because it has not arisen due to an identifiable cost being incurred nor is it something that can be fair valued, it cannot be recognised.

Question 4

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

No, at least not in the short term, and not without further research into the benefits of increasing the extent to which intangibles are recognised as assets, some analysis as to which intangibles are reflected in the difference between market value and balance sheet value and how realistic it is that such intangibles can be valued.

Further, if changes are made to the Conceptual Framework and/or specific accounting standards in order to improve the accounting for intangibles as an isolated class of asset, then a detailed analysis would be needed of other standards to ensure that the principles and accounting treatments applied to other assets and other unrecognised sources of value are consistent.

Question 5

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

In relation to disclosures that help their understanding of the generation of economic value, investors expect to see disclosure of research and development, or maintenance expenditure to understand how essential assets are maintained or enhanced.

IAS 38 prescribes disclosures relating to intangible assets, but other than a brief reference to research and development expenditure there are currently no specific requirements for the disclosure of unrecognised 'intangibles', in particular 'future oriented intangibles'. There is also a requirement in IAS 1 Presentation of Financial Statements for an entity to present additional line items in profit or loss when such presentation is relevant to an understanding of the entity's financial performance. This requirement is not specific to intangibles but could theoretically include such expenditure.

We would therefore encourage improved disclosure, where possible, on the expenditure on intangibles. For example, two companies in the same business could have a different attitude to spending on intangibles, including those that are considered to be future oriented. One company might spend very little whilst the other might spend significant amounts. The requirement to disclose expenditure would therefore differentiate those companies that do invest in future oriented intangibles and those that do not, and in the case of the former highlight the potential for that business to receive higher financial returns in the future. This information would be useful to investors.

However, we would caution specific disclosures on the face of profit and loss (as implied by section 3.5) which show net income before investment in future-oriented intangibles and the expenditure on future-oriented intangibles. There is a danger that companies could use this disclosure to present results in a more favourable light, in the same way that concerns have been raised about companies describing recurring expenditure as 'exceptional' and disclosing this separately to other expenditure. As stated above, there is already an option under IAS 1 to present additional line items. We would therefore prefer the presentation of intangible expenditure in the notes as set out in section 3.10.

There may also be difficulty in determining what expenditure is genuinely expected to benefit future periods and companies may therefore be overly optimistic in the allocation process. Further would 'cost' include a share of indirect costs or simply reflect direct expenditure? If the potential requirement to report separately were to be taken forward, we agree that supplementary disclosures, such as those described in section 3.9, would be necessary so that comparisons could be made across different companies, and that an accounting policy would be required to explain how management make the distinction between current and future-oriented expenditure.

Finally, as outlined in the discussion paper, challenges exist around measuring intangibles at cost. The discussion around the proposals relating to the disclosure of expenditure on intangibles assumes that intangibles are capable of being measured at cost and that expenditure can be allocated to a particular intangible which in many cases is not possible. The usefulness of such disclosure is therefore questionable as it may only be possible to identify expenditure in limited circumstances and could lead to a mismatch in reporting by different companies. In our opinion, better narrative disclosure concerning intangibles would be more useful.

Question 6

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

Firstly, we would point out that there are already various requirements and sources of guidance regarding narrative disclosures, which encompass unrecognised intangibles. One might therefore expect that narrative reporting should already be capable of complementing information provided in the financial statements regarding recognised and unrecognised intangibles. It is therefore unclear as to why the existing requirements are apparently not at present sufficient to encourage this disclosure.

For example, whilst the IASB Conceptual Framework states that only items that meet the definition of an asset are recognised in the statement of financial position, the framework states that even if an item meeting the definition of an asset is not recognised, an entity may need to provide information about that item in the notes. (para. 5.11).

From a statutory perspective the strategic report requirements set out in the Companies Act 2006 require the report to be fair and balanced, and in the case of a quoted company, requires a description of the company's business model. For those companies that comply with the UK Corporate Governance Code the directors should state that they consider the annual report and accounts, taken as a whole, are fair, balanced and understandable, and provides the information necessary for shareholders to assess the company's position, performance, business model and strategy. Whilst we understand that there is no formal definition of 'business model' one way of articulating it is what the company does, how it does it and how it creates economic value. The generation of economic value will often be supported by both recognised and unrecognised intangible assets.

The FRC Guidance on the Strategic Report issued in July 2018 states that the strategic report should include information relating to sources of value that have not been recognised in the financial statements and how those sources of value are managed, sustained and developed, for example a highly trained or experienced workforce, natural capital, intellectual property or intangible assets, as these are relevant to an understanding of the entity's development, performance, position or future prospects. (Para. 4.5). Sections 7A and 7B also refer to sources of value which include intangible assets and the identification of resources and relationships that have not been reflected in the financial statements because they do not meet the accounting definitions of assets or the criteria for recognition as assets. The guidance uses an entity's workforce as a specific example and refers to other sources of value which may include: corporate reputation and brand strength; customer base; natural resources; research and development; intellectual capital; licences, patents, copyrights and trademarks; outsourcing relationships; and market position.

The FRC Lab has also published a report on Business Model Reporting (October 2016) which discusses some of the attributes of good business model reporting that investors would like to see, such as key inputs (including relationships and resources) and how they are maintained and enhanced.

However, on the basis that the narrative reporting of recognised and unrecognised intangibles could be improved, we note the suggestions set out in section 4 of the discussion paper. We agree that disclosure should focus on those intangibles that play a key role in the business model, and that disclosure of the reasons for selecting those intangibles would be useful. This would be consistent with the qualitative disclosure requirements of key performance indicators and alternative performance measures (APMs). The use of appropriate metrics may also be helpful, including their definition, which again is consistent with best practice for APM disclosures.

Finally, we note that section 4.10 states that it is doubtful that the value of an intangible will often be a particularly useful metric. This would appear to contradict the suggestion of including a table presenting the movements on the cumulative amount of future oriented expenditure in section 3.

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?

Improved disclosure in a particular area of reporting often develops over time. This is achieved through peer pressure, publication of best practice examples, discussion with investors, FRC focus, for example the annual review of corporate reporting, FRC Lab studies, and updates to guidance such as that relating to the strategic report, etc.

We do not believe that further regulation is required. In our view, and as discussed above the existing legal and regulatory requirements are already sufficient.

Section 5.4 refers to guidance as being a more suitable means of encouraging the evolution of best practice. We agree that guidance can sometimes be helpful where it is focussed and its purpose is clear. This will be important going forward as we note that in the context of issuing guidance, recommendation 31 of the Independent Review of the Financial Reporting Council led by Sir John Kingman notes that '…the new regulator should be more sparing and disciplined than the FRC in promulgating guidance and discussion documents. These documents should only be issued if they are genuinely useful…'

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 have not responded to this question as it appears more to be aimed at investors and analysts. However, it would be useful for companies to know what information investors use. This could be ascertained through studies such as those of the FRC lab.

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?

As stated within the response above, various statutory requirements and sources of guidance regarding narrative disclosures which encompass unrecognised intangibles already exist. An FRC Lab project could consider how the various existing reporting requirements and guidance could be brought together to provide more useful information for investors and encourage best practice in the reporting of intangibles.