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Dear Mr. Lennard

Discussion paper – Business Reporting of Intangibles: Realistic proposals

We welcome the opportunity to comment on the FRC's – *Business Reporting of Intangibles: Realistic proposals.*

As noted in the discussion paper, traditional accounting and reporting frameworks do not comprehensively capture the value of intangibles in today's businesses and economies. Whist we agree that there should be a limit to what is captured in the financial statements, we share the FRC's concerns on the need for enhanced reporting on how an entity generates value. We support the FRC's discussion paper as a positive initiative in improving the quality of information provided, and consider the strategic report as an ideal medium for reporting on intangibles beyond those recognised in the financial statements. However, caution should be applied to maintain the focus of the exercise on decision-useful information which supports long-term capital allocation and the effective exercise of investor stewardship.

Reverting to the accounting, practice shows that current principles result in different outcomes in situations with similar substance. In our view, there is scope for progress beyond the proposals made in the Discussion Paper. We suggest that the FRC consider whether the UK can take a lead to drive global improvement.

Our responses to the questions set out in the discussion paper are included in the attached appendix 1. Examples of the wider accounting issues are included in appendix 2 as a supplement to our response.

Please contact Claire Stagg (on 0207 311 3761) or Matthew Chapman (on 0207 311 3236) should you wish to discuss any of the comments further.

Yours faithfully

KPMG LLP

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Appendix 1 – answer to specific questions

Introduction

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

We agree there are aspects within intangible assets accounting that need attention, examples of which we outline in appendix 2 to this response. Nevertheless, we agree with the fundamental position that not all intangibles should be recognised as an asset in the financial statements.

Due to this, whilst we agree with that it is important to improve the business reporting of intangibles, we observe that financial statements are not the best place to provide all information on an entity's intangibles. The IASB's concept of broader reporting recognises this and in our view its work in this area, together with the FRC's *Guidance on the Strategic Report,* provide the most appropriate platform for addressing users' additional information needs.

Asset recognition

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

We do not agree with the first condition proposed. Our main concern is that the basis is arbitrary and reflects neither the entity's efforts exerted to create a value-generating resource (historical cost) nor the value extractable from the outputs of such activities (fair value). It is unclear why such information would be relevant. The proposed condition also introduces additional subjectivity, eroding the reliability of the information presented.

The second recognition condition proposed, that recognition commences only when economic benefits are expected to be derived, does not appear to be different to the current accounting and we do not have comments on this.

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

We agree that for many intangibles, fair value may not be a suitable measurement basis due to the difficulty of applying any of the recognised fair value approaches. This is particularly so for an internally generated intangible. One acquired in a business combination is recognised at fair value, of course, but that is only a means of allocation of an actual cost of the acquirer. The internally generated one is pure valuation in the performance statement (valuation in excess of cost).

We also agree that the inclusion of some business combinations intangibles within an amortised goodwill figure (we should welcome a return to amortisation of goodwill) could help eliminate the valuation difficulties. This may seem contrary to the provision of more granular disclosure, but we note that many of the IFRS customer-related intangibles are difficult to distinguish from goodwill.

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

We agree that there is a need to improve existing accounting treatments in order to promote greater consistency of treatment in situations which are substantively equivalent. Examples of our observations in this respect are summarised in Appendix 2 to this response.

Financial statements disclosure

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

We disagree with the proposal to introduce disclosures around cumulative amounts of future-oriented expenditure, its quasi-amortisation and other movements. Our concern is that such disclosure is tantamount to capitalisation anyway. The same data (and effort in preparing them) are required of the company; and it may invite the reader not to distinguish between capitalised and written-off expenditure.

Although we disagree with the proposal to present information on a cumulative basis, we appreciate that the disclosure of information that addresses future-oriented expenditure on intangibles - in particular, on those intangibles that are important to the operation of the entity's business model and execution of its strategy – can be important to users and could be included within the strategic report. Consideration needs to be given to how such information is analysed; should it, for example, be split between expenditure to maintain the entity's productive capacity and those that are intended to enhance its capacity? Providing an appropriate focus on materiality is maintained, we would expect that the information required would already be monitored internally as part of the routine operation of the business, so could be provided by entities.

We also believe that it may be more useful to present past expenditures over time to show the trend of whether 'investment' in intangibles is being maintained.

Narrative reporting

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

With the exception of the development of industry-specific standardised definitions and calculations of metrics, we agree with the proposals. With the diversity that already exist in practice, we envisage that there will be difficulties in developing such standardised metrics. More importantly, however, our concern is that standardised metrics could reduce the provision of entity-specific information.

Although comparability is desirable, it is important not to create apparent comparability between entities within the same industry that are pursuing different strategies. We would therefore prefer a market-based approach to the selection of measures supported by transparency over the choice, basis of calculation, and assumptions of each measure presented.

However, we should not rule out that with experience over time some degree of standardisation might become practical and useful.

Implementation

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 have noted the imperative for information on intangibles that complements the financial statements. Assuming preparers also include both management and those charged with governance, we therefore agree with the identification of participants set out in section 5.

Further questions

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?

This is not applicable to us as an audit firm.

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 indicated in our responses above, we strongly believe that there is a need to improve the quality of information provided on an entity's intangibles. The provision of information on intangibles is a global challenge that is best dealt with through the same channels as traditional financial reporting. Therefore, we think the FRC should focus on supporting development through the IASB. In our view the FRC has much to contribute both from the innovations introduced in its *Guidance on the Strategic Report*, and through the use of the Financial Reporting Lab as a channel for preparer-investor dialogue and innovation on this important topic.

As noted in our response to question 4, Appendix 2 contains examples of disparity in accounting permitted within the existing accounting principles. These observations highlight that the initiative to enhancing existing approach to intangibles would benefit from a much wider exercise.

Appendix 2 – issues warranting a revisiting of accounting standards

The existing accounting requirements on intangible assets result in i) variation in accounting treatment depending on circumstances, but also ii) in extreme cases, departure from reflection of the nature and magnitude of intangibles. Some examples we have observed in practice are listed below.

1. **Variation in timing of capitalisation**
   We acknowledge that judgment will always be required in determining the precise point at which there will be "probable future economic benefits" and hence capitalisation commences. However, the practical application of the test would benefit from gathering and assessing some proper empirical data and any implications it might identify – is there wide variation and why? For example, there is anecdotal evidence that the current test can result in the onset of capitalisation in the pharmaceutical industry at a stage quite close to completion of the project.

2. **Own development vs. other acquisitions**
   It is well known that the balance sheet of an entity that develops its own intangibles may look very different from that of one that obtains them through business acquisitions; and many companies do both with the result that within that single company similar intangibles are treated fundamentally differently. The same is true of own development compared with separate purchase of an intangible (not in a business combination). However acquired, through business combination, separate acquisition or own development, consideration should be given to achieving consistent accounting. All solutions to this should be examined, eg including aligning business combinations with own-development (ie, accepting some immediate write-off of the cost allocated to the in-process R&D that would not qualify as own-development spend).

3. **Accounting for variable payments (e.g. milestone payments)**
   There is no clear position on how an entity should account for milestone payments for the purchase an intangible asset based on the success of the project after further development by the buyer. As a further complication the seller may also be retained to continue to conduct the development work on behalf of the buyer (for payments that may or may not be separately identified). We are aware that some treat these as a contingent payment and capitalise, as a cost of original acquisition, when the payments have been made. Should, however, these payments be recognised as cost when they become payable, or when probable or when the asset is acquired and, if so, at what value? IFRIC has declined to address this, but it remains an issue.

4. **Derecognition**

Applying derecognition principles to intangible assets can be a complicated exercise due to their divisibility. Although the current accounting standards prescribe how the resulting revenue should be recognised, there is little guidance on when the entity is considered to have lost control over the underlying intellectual property. This is further complicated in situations where the intangible asset forms part of a larger asset (e.g. one molecule within a database) and some apportionment is required to reflect the disposal or retirement of the associated economic benefit.