MAZARS

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Dear Andrew

Business Reporting for Intangibles, Realistic Proposals

1 Introduction
Mazars, the international, integrated and independent organisation specialising in audit, accountancy and advisory services, strongly welcomes the publication of the Discussion Paper 'Business reporting for Intangibles, Realistic Proposals' and is pleased to submit its response to it. As of 1st January 2019, Mazars operates as a truly internationally integrated partnership in 89 countries and territories with correspondent offices in an additional 14 countries. Mazars draws upon the expertise of 23,000 women and men. In the UK, Mazars currently has around 140 partners and over 1750 employees, and is ranked one of the top 10 accountancy firms nationally.

2 FRC's focus should be on the narrative reporting on intangibles
We believe FRC's focus as regards intangibles should be on the area in which it can directly bring about positive change, namely the quality of narrative reporting by UK listed companies and how it can be substantially enhanced to better meet the needs of shareholders and other stakeholders.

3 Reporting on intangibles has not kept up with the growth in their importance in business
Reporting on intangibles has not kept up with the substantial growth in their importance in business which has occurred for a number of linked reasons: advances in technology, globalisation, the move towards 24/7 social media, different patterns of customer behaviour and changes in the relationship between business and society. Intangibles represent the vast majority of the value of most major businesses and this is not properly reflected in the reporting of them in the annual report.

4 Major study needed on reporting by listed companies on intangibles and investors' views
To ensure proposals for change are appropriately evidence based, a study should be undertaken of current reporting practices by UK listed businesses and on the views of investors and other stakeholders of how they can be improved.

5 Supportive of much better metrics being provided on intangibles
We are very supportive of much better quality metrics on intangibles being provided in the narrative report in the manner suggested in the Discussion Paper. The emphasis, should, as suggested, be on reporting on intangibles that are closely tied to the current business model and, we would add, other substantial intangible assets, if applicable. The metrics should also reflect those used by management, be clearly defined, prepared on a comparable basis with industry competitors where appropriate, cover a number of periods and include suitable discussion of the figures provided.

6 Not supportive of showing future orientated expenditure on intangibles on face of P&L
We would not support having profit/loss being shown on the face of the profit and loss account before and after future orientated expenditure on intangibles and have reservations about whether such a figure could be reliably determined. If this is possible, it may be appropriate to disclose the relevant figure in the notes to the profit and loss account.

7 Listed companies to discuss difference between net book value and market capitalisation
Companies should discuss the difference between their net asset value and their market capitalisation with particular reference to their principal intangible assets that have not been recognised in the financial statements. The discussion could include commentary on how the figure has moved over the period under review and other relevant issues such as if the movement in the period is different from key competitors. Such commentary should have regard to the IIRC Framework- Integrated Reporting and the relevant types of capital it identifies, namely human, intellectual, social and relational and natural (the remaining two capitals being manufactured and financial). It will also be important for the FRC's project on intangibles to be linked into its broader one on 'The Future of Corporate Reporting'.

8 Regulator should properly review narrative reporting and it should be audited
To provide the necessary confidence to the users of narrative reports that information on intangibles is fair balanced and understandable, it should, as proposed by the Kingman Review, be subject to review by the regulator in the same way as that in the financial statements and should be audited, an issue for consideration by The Brydon Review on the Future of Audit.

9 IAS38 Intangible Assets should be subject to thorough review
We fully support a thorough review of IAS38 Intangible Assets given that it has very surprisingly remained unchanged for the past 15 years despite the substantial growth in their importance to business over that period. The review should also consider the optimum relationship between IFRS and the IIRC Framework- integrated Reporting going forward and be willing to consider major changes in that relationship.

10 Response to detailed questions
Our response to the detailed questions is contained in the appendix which is attached.

11 Further discussion
If you would find it helpful to discuss any aspect of our response, please contact Anthony Carey at the number above.

Yours sincerely

Mazars LLP

Mazars

Business Reporting for Intangibles, Realistic Proposals

Appendix – Response to detailed questions

Section 1 Introduction
Question 1
Do you agree that it is important to improve the business reporting of intangibles?
We consider it essential to improve the business reporting of intangibles as a matter of priority.

Intangibles drive the performance, value and prospects of most modern businesses and are currently very inadequately addressed both in the financial statements and in corporate reporting more widely. This seriously damages the relevance and reliability of financial and, more broadly, corporate reporting and raises related issues regarding confidence in audited statements.

IAS38 Intangible assets was last revised in 2004 and since then there have been tremendous changes in business due to developments in technology as well as the interlinked issue of the relationship between business and society and these have significant implications for intangibles that need to be addressed.

Section 2 Which intangibles should be reported as assets?
Question 2
Do you agree that an intangible should be recognised at cost under the two conditions set out above in (i)?
We are clear that in its current review the FRC should focus on narrative reporting by listed companies, the area in which it can bring about change in the near future in the corporate reporting by listed companies in the UK. The rest of the comments in this response to Question 2 relate to issues that should be considered in the review we recommend by IASB of IAS38 Intangible Assets.

We do, however, consider that a review is needed, with an open mind as to the outcome, of the definition of an intangible asset to ensure that it is consistent with the realities of modern business.

We agree that an asset needs to be controlled by the entity and to have clear boundaries not overlapping with those of other assets if it is to be recognised in the financial statements but this ability to be separately identified does not necessarily mean, as required at present in IAS38 intangible Assets, that it be 'capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged' at least not if this refers to the current shape of the business. In this context we note that the concept of separability is defined differently, and more restrictively, in IAS38 Intangibles Assets than in IFRS3 Business Combinations as regards identifiable assets.

Question 3

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

The statement in the Discussion Paper that 'when an intangible asset is acquired by purchase, its cost will be as evident as any other asset' is very open to challenge. This is only true when an intangible asset is acquired on its own rather than as part of an acquisition of a business. Moreover, as noted in the basis for conclusions (BC313) of IFRS 3, the purchase price may not accurately represent the value of the business acquired. While some of the points here could apply to any asset, some apply more, or particularly, to intangible assets.

Where a business is acquired, the business is looked in its entirety and the buyer will not necessarily have attributed values when deciding on the purchase price to individual intangibles as they will plan to use the assets acquired in combination with each other.

The attributable value, and hence carrying amount, of individual intangibles in a business combination will be determined by reference to broadly accepted valuation techniques which could justify a range of values for a particular intangible asset. Having decided on the values of individual intangibles, the residual difference between the value of individual intangibles and the overall purchase price is treated as goodwill. The purchase price enables a reasonableness test to be undertaken as to the reasonableness in aggregate of the carrying amounts of the individual intangibles and goodwill but still allows for variations in recommended carrying amounts for individual assets and goodwill between different values and this may also have an impact on the resultant annual depreciation charge for the assets concerned. Thus, the process for identifying the initial carrying amount of acquired intangibles clearly masks a potentially significant degree of subjectivity in the valuation attributable to individual intangible assets. Hence, relying on the overall purchase price to provide measurement reliability as to the carrying amount of each of a potentially significant number of different intangible assets is very open to the challenge that accounting convention is being afforded precedence over business reality.

In view of the above, we therefore believe it is time to conduct an evidence-based review of the assumption that the carrying amount of intangibles can be measured with a far greater degree of certainty than their internally developed counterparts. This needs to consider the evidence available on the reliability of measurement techniques for particular types of intangibles. If such techniques are deemed reliable, they could be used to determine valuations, albeit not costs, of creation, for internally generated intangibles.

If, as the Discussion Paper suggests 'that for many intangibles, the measurement uncertainty of fair value is so great as to call into question whether it could provide a representationally faithful depiction' then, for the reasons discussed above, such reservations could at least to some extent be applied to including individual intangibles acquired in a business combination at their cost yet this is a widely accepted practice

That said, we strongly accept as a practical measure of prudence that reasonable evidence is needed of future economic benefits before research costs can be capitalised though the nature of creation of intangibles is such that the expected costs and expected benefits may well change over the course of the development of particular intangibles.

As made clear in our response to Question 2, we believe that its focus of the FRC's current project should be on the narrative reporting of intangibles by listed companies.

Question 4

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

Yes, most definitely, for the reasons discussed in the response to Questions 2 and 3 above. The review should also consider the optimum relationship between IFRS and the IIRC Framework- integrated Reporting going forward and be willing to consider major changes in that relationship.

In saying this, however, we strongly support the view that any changes 'would need to be carefully assessed to ensure that improvement in relevance is not obtained at a disproportionate cost of reducing the objectivity and reliability of financial statements'. Moreover, given the inherent subjectivity in the carrying amounts of intangibles, whether acquired or internally generated, auditing of them will be crucial to increase market confidence in the figures provided and this in turn will only occur if there is confidence in the independence and skills of the auditors.

Section 3 Disclosure of expenditure on intangibles

Question 5

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

We would need further evidence to be persuaded of the merits of the proposals. The proposals imply that the costs attributable to creating future intangibles can be reliably identified and that the uncertainty meaning they cannot be recognised results from uncertainty as to future economic benefit. Empirical evidence is needed to demonstrate that this is the case.

The two situations focused on are advertising and staff training which are not intangibles in their own right but rather inputs into intangibles, the intangibles presumably being brand value and staff quality/loyalty. In both cases expenditure on given initiatives in a current period is likely to benefit both that period and subsequent periods. Whilst it may be possible to make an allocation between current and future periods there is clearly a risk that it will be relatively arbitrary in nature. Furthermore, in the case of intangibles, it can be difficult to establish the link between expenditure incurred and future value created.

It may be more practical either to simply ask for details of total expenditure on particular areas, such as those mentioned, which it is thought often lead to the creation of intangibles or, if it is considered after a careful review of the evidence that a reliable allocation can be made it should be by reference to the intangible being created rather than the nature of the expenditure. Even so, we would not support showing the total expenditure on future-orientated creation of intangibles in the way suggested (namely net income before investment in future-orientated intangibles, and expenditure on future orientated intangibles, analysed by nature). This would be equivalent to a return to net income before and after exceptional items. If such expenditure on creating intangibles yielding benefit in future periods is to be aggregated it would be best dealt with by way of a note to the financial statements.

Section 4 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?
We strongly agree with the statement in the Discussion Paper that 'narrative reporting enables the provision of information on unrecognised intangibles: it can also amplify what is reported within the financial statements'.

As mentioned, narrative reporting is also the area where FRC can most quickly make progress as it is within its jurisdiction whereas improvement in the financial statements largely rests with the IASB though we believe far more integration between the financial statements and narrative reporting is needed.

In understanding the scale of improvement needed in the UK, it would be helpful to have clarity on the nature of the practices across listed companies and the extent to which it is considered by investors and others that they provide a fair balanced and understandable analysis of the key intangibles in the business. Our view is there is substantial room for improvement.

We fully agree that that 'it would be unwise to prescribe a list of which intangibles should be discussed in narrative reporting'. As proposed, we consider the focus should be on those intangibles most relevant to the entity's business model. This should normally cover the principal intangibles but where there are others of substantial value to the business these should also be covered. We also agree that management, in fact the board, should discuss the reasons for their selection of those intangibles that it will discuss in a systematic way in its narrative reporting to the extent not covered in the financial statements. The International Integrated Reporting Framework provides a useful, and not excessively prescriptive, taxonomy for such an exercise.

The key challenge is how to draft the wording of the requirement as regards narrative reporting such that it leads to the necessary substantial enhancement in the quality of reporting as the current wording seems sufficiently broad to encourage at least reasonable disclosure relating to intangible assets. Intangibles already account for the majority of the value of most leading listed businesses but this currently does not seem to be reflected in the depth of the reporting. It is not just about whether an increase in the volume of disclosure is needed, but also the extent to which that currently provided offers real insight into how the principal intangibles in a business are contributing to the performance, position and prospects of the business, including challenges being faced in relation to them and how they are being addressed.

We fully share the view expressed in the Discussion Paper that 'the usefulness and credibility of narrative information may be enhanced by the inclusion of metrics' indeed narrative information *will* be enhanced by well-chosen metrics that both facilitate comparability with other businesses in the sector and, where appropriate, highlight distinctive features of the business concerned.

We further agree that:

- it is probable that metrics that are most relevant to investors are the same as those used by management in running the business (and details of those actually used will certainly provide useful information to readers of the annual report)
- the metrics should both relate to intangibles that are relevant to the business and provide a meaningful insight into their potential
- the definition of metrics disclosed should be clear
- more insight will result from metrics where information is disclosed for several periods in relation to them, calculated on a comparable and consistent basis,
- management, in fact the board, should provide their views of the factors that have caused change in the metrics and how the reported metrics compare with management's realistic targets
- there should be appropriate disaggregation of metrics
- there would be merit in seeing how certain metrics could be established for use in particular industries using common definitions

We also consider companies should be asked to discuss the difference between their net asset value and their market capitalisation. While this should not aim at a precise reconciliation between market capitalisation and net asset value, it should be guided by the magnitude of the ratio between the two. It would be helpful for the board to be asked to consider the principal intangibles which it is considered contribute to such a difference and to describe how they believe the extent or quality of these has changed over the period being reported on with regard to the metrics mentioned above.

We would not necessarily share the view set out in the Discussion Paper that ''it is doubtful that the value of an intangible will often be a particularly useful metric". Whilst this is likely to be true if provided with little explanation of how it has been calculated, if this explanation is provided together with a multi-period analysis of how it has changed, and the perceived reasons for such changes, it could well be of assistance to the users of the annual report.

In addition to the improved reporting of intangibles, the usefulness of additional information on intangibles provided to investors and other users would be significantly enhanced by a much more thorough review by the regulator of narrative reporting by listed companies, as proposed by the Kingman Review, and by narrative reporting being subject to full assurance. This latter subject should be considered by Sir Donald Brydon's Review on the Future of Auditing.

Section 5 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?
As discussed further in our response to Question 9 below, we believe all main stakeholders in corporate reporting should be involved in developing the proposals and/or providing practical insights on issues arising from their implementation. This would include shareholders, the workforce and other stakeholders in the business, management and audit committees, regulators, auditors and member of the academic community.

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.
There is clearly significant information available when assessing and valuing brands both within the business and outside of it on issues related to, for example, customer and employee satisfaction. Of the information external to the business, some will be publicly available, other gathered by organisations for sale to businesses or those dealing with them.

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 discussed above, we consider high quality information is needed on current reporting practices, relating to intangibles in the accounts and disclosures through narrative reporting, by UK listed companies and on the views of investors and other stakeholders of information in narrative reporting that they would find useful.

In addition, auditors should be consulted for their opinions on the challenges associated with providing assurance on enhanced information on intangibles and how they might best be overcome.

As mentioned in response to Question 4, as well as the FRC or its proposed successor body, the Auditing, Reporting and Governance Council, improving narrative reporting by listed companies, it also needs to be discussed what would best be done at global level by IASB and other organisations such as the International Integrated Reporting Council (IIRC).