WICI

Global Network
The World Intellectual Capital/Assets Initiative
www.wici-global.com

30 April 2019

Mr. Andrew Lennard
Financial Reporting Council (FRC)
8th Floor, 125 London Wall
London, UK
EC2Y 5AS
intangibles@frc.org.uk

Re: ***Response by WICI to the FRC's "Business Reporting of Intangibles: Realistic 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 I submit on behalf of the World Intellectual Capital/Assets Initiative (WICI) Global Network.

Overall, we believe that the FRC's proposals are an important step in improving the reporting of intangibles vis-à-vis the current situation.

We can see the merits of capitalizing expenses related to intangibles, where certain strict conditions are met – particularly relating to the reliability of information (point 8, pp. 3-4) as well as the income statement differentiation of intangibles-related expenditures that are future-oriented, when a recognition as assets of these expenditures is not possible. We would like to push FRC further to look for a refinement of its proposals to make them more robust and widely acceptable.

Where intangibles are separable, legally identifiable and used in business operations, we would respectfully suggest also considering the possibility of recognizing and measuring these resources at fair value, similar to fair value level 3 securities and investment properties with no market prices.

It is time, we believe, to meaningfully address the financial reporting and disclosure of intangibles. In this respect, we believe that the FRC proposals go in the right direction.

If the FRC is interested in internationally socializing and discussing its proposed solutions, WICI could be available to consider organizing a series of national multi-stakeholder meetings/roundtables (France, Italy, Germany, Japan) to discuss further the options of dealing with intangibles in financial reporting and the contribution they make to value creation. Moreover, on the 7 November 3rd WICI Europe Conference to be held in Brussels, we can organize a Roundtable for discussing FRC proposals.

Our attached memo sets our views to the proposals in detail. We hope that you find our response useful in your deliberations on this important project.

Sincerely,

Prof. Stefano Zambon
Chair, WICI Global Network

Response of the
World Intellectual Capital/Assets Initiative (WICI) Global Network
to the FRC's "Business Reporting of Intangibles: Realistic Proposals"

Q1: Do you agree that it is important to improve the business reporting of intangibles?

Yes

Intangibles represent a major part of corporate value and essential to many business models to ensure the long-term success of the company. Hence, it is very important to represent, disclose and explain these resources in financial and business reporting. Integrated Reporting has made great strides in giving recognition to the importance of intangibles in effective business reporting to capital providers.

Over the years, WICI and its promoting parties have issued several documents and tools on the representation and reporting of intangibles. The **WICI Intangibles Reporting Framework** (cf. attachment) published in September 2016 is one of the most important of these documents. Most recently, the **Business Management Design Sheet** issued in 2018 by the Cabinet Office of Japanese Government, may be an effective supporting tool to visualize in the notes the essence of value creation mechanism of the company in one page (cf. attachment).

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

Qualified Yes

As long as we see investments in intangibles treated as a cost – and often pooled with other cost items – in the income statement under the current financial reporting framework, we cannot correctly understand, nor be fairly informed about the essence of intangible assets. Measurement of intangibles at cost may indeed be misleading.

However, differently from para. 2.14 of the FRC document, and despite the above considerations, we still think that the recognition of certain intangibles (e.g. research-related) at cost by presenting the expense related to them could provide relevant information to capital providers.

The capitalization of costs related to intangibles, where reliable and subject to audit, on the face of the balance sheet could be an improvement over the current situation, even though measurement at cost seldom represents the value of intangibles to the business.

Another area of significant professional judgement is the separation and allocation of costs that may be complex and highly subjective, which underscores our point on reliability.

We think it is useful to evidence that a similar capitalization process for costs with uncertain future economic benefits is nowadays allowed by IFRS 6 for the expenses related to oil and gas explorations. Another useful example is provided by IAS 23 that mandates the capitalization of interest expenses on qualified assets, i.e. those taking long time to get ready for use.

On a more general level, it is not clear to us why it is commonly accepted to have assets, such as securities with no active market, whose value is totally contingent upon financial models (fair value level 3), or investment properties fair valued according to a discounted cash flow formula (IAS 40), whilst intangibles, that are vital to businesses, are "hidden away" from assets because we might have some issues and uncertainties in their valuation process. In other words, either we accept the use of the "mark to model" for valuing assets or it is irrational not to accept it only for intangibles.

Ideally, separable intangibles should be recognized at their value in use, i.e. by identifying their contribution to the process of value creation. In this respect, even though the same intangibles are utilized by two companies, their value is not the same owing to the specific role of these resources in the value creation process of each organization and, then, the value created for the businesses where intangibles are used. However, we realise that applying value in use to intangibles can be a long-term goal.

Therefore, in line with the above issues and concerns, we would propose consideration be given to the option of recognizing intangibles that are separable, legally identifiable and used in business operations (such as brands, patents) at **fair value**. It seems to us illogical and counterproductive for the relevance and consistency of financial reporting not to use fair value for intangibles that have clear characters of assets commonly and successfully employed in business. As we said, we cope with estimation at fair value for other assets, so it follows that intangibles should not be considered any different.

Also, it is relevant to observe that in many cases intangibles are more resilient assets to a company than properties and securities (e.g., Coca-Cola brand name, patents linked to a blockbuster drug, etc.)

We understand that we are suggesting introducing a further estimate in the current financial reporting system, but we are concerned about the importance of these "new" assets and the importance of showing their value in the accounts in a relevant way. We are open to consider other, feasible solutions.

Q3: Do you agree with the assumptions the paper makes regarding measurement uncertainty of intangibles?

Qualified Yes

We cannot appropriately measure intangibles based on the notion of the accounting period. This makes it difficult, if not impossible, for various intangibles to be measured at fair value, especially if they are related to a medium-long term development project.

However, as pointed out in our response to Q2 above, for some intangibles that are separable, legally identifiable and already employed in company operations, we should consider measurement at fair value appropriate, in order to address the serious underestimation of company assets and the misunderstanding of its value creation process.

As pointed out in Q2, we observe that measurement uncertainty is not an unsurmountable obstacle for reporting assets that are affected by a comparable amount of measurement uncertainty as that relating to separable intangibles used in business.

We think that the starting point for appropriate and relevant measurement of these resources is the analysis and identification of material intangibles for company value creation and the clarification of the role or function of intangibles in this process, as is clearly shown – for example – in the Business Management Design Sheet of Japanese Cabinet Office mentioned in the answer to Q1.

Q4: Do you agree that existing accounting standards should be revisited with the aim of improving the accounting for intangibles?

Yes

We think that any revision to standards should be confined to IAS 38. We remind that the IASB Chairman, Hans Hoogervorst, noted in 2012 that the treatment of intangibles in IAS 38 was "rudimentary". Thus, we support your statement that IAS 38 should be reviewed to evaluate whether, at a minimum, its requirements are consistent with the new Conceptual Framework – particularly in terms of recognition and measurement principles.

However, we believe the level of ambition remains too conservative, as we acknowledge that the standard setting process can take long time.

Q5: Do you agree with the above proposals relating to expenditure on intangibles?

Yes

We think that, conceptually, intangibles that meet the definition of an asset should be recognised as such. An expenditure that gives rise to future economic benefits is typically capitalized, except for intangibles.

We support, as a transitional step, separate identification of such expenditure so that investors are furnished with relevant information to assist them in considering the nature of the entity's investment in intangibles. It is not radically different to the treatment of operating leases under IAS 17 which has in time been replaced with effectively capitalising all leases under IFRS 16.

Making clear past investment in intangibles in a timeline will contribute to clarifying the appreciation of intangible investments of the company, leading also to a more accurate prospective evaluation of future profit.

This information segregation would enable financial statement users to develop their own measures of the firms' current period earnings (i.e., by excluding the future-oriented expenditures on intangibles) and may improve comparisons of the current period financial performance of companies across time and space.

We also consider positively the management's footnote commentary related to its reasoning behind the information differentiation, which is 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 view of intangibles investments.

It would be better if this annual income statement differentiated information on intangibles-related expenditures could be supplemented in the notes, perhaps showing comparative figures with previous years, so to create a consistent timeline information about these investments.

Q6: Do you agree with the proposals aimed at improving the quality of information on recognised and unrecognised intangibles in narrative reporting?

Partially agree

We, agree in principle, with the general notion that an improvement to the narrative reporting related to recognized and unrecognized intangibles is important and highly desirable. Narrative reporting (e.g., management commentary, other financially related documents) can make a significant contribution to providing users with information about the "hidden" intangible wealth of a company, especially for those "soft" intangibles that cannot be recognised in the balance sheet or that they are not "generated" by specific costs (customer satisfaction and loyalty, corporate reputation). Here the role of KPIs and management commentary is crucial.

In this respect, rather than trying to "reinvent the wheel", we would suggest referring to reporting frameworks and KPIs that have already been developed and tested by other bodies, such as the WICI Global Network (e.g., its industry-based KPIs) and the International Integrated Reporting Committee (IIRC). Indeed, integrated reporting, Intellectual asset-based management report, WICI Intangibles Reporting Framework appear to be quite helpful in this perspective. KPIs are different from a company to another, and therefore the KPI Concept Paper by WICI will help users understand the basic nature of KPIs and the effective way to utilize them.

It would be important that the information on intangibles be comparable. Perhaps a way forward could be to follow the "inverted pyramid approach" suggested by WICI, which includes three levels of disclosure: the lowest level sets a minimum common denominator of KPIs, i.e. a few intangibles-related monetary and non-monetary indicators and metrics that could be applied by all the companies (e.g. R&D expenses, training expenditures, customer satisfaction); a second level where industry-specific indicators and disclosures can be selected from a predetermined set of sector-specific metrics and KPIs (e.g. WICI industry KPIs; SASB in the sustainability field); and a third level where companies are encouraged to complement their metrics and KPIs on intangibles on a voluntary basis.

Certainly, the meaning of the concept "comparison" when dealing with intangibles changes: we cannot indeed think of a punctual comparison "indicator by indicator" or "disclosure by disclosure". Conversely, the selection by the companies of certain KPIs is in itself a point of comparison between these companies.

Q7: 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?

To grasp and utilize a company's own intangibles is indispensable for a company to create value or to differentiate itself from other companies. Every company should voluntarily explain the intangibles available and the associated management philosophy in its business reporting in order to raise the accountability of the company. It would be in the company's and its manager's best interest to evidence their "hidden" wealth.

Despite the obvious resistances to this accounting change, we are convinced that many corporates and standard setters would well understand the need for these measures and disclosures.

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).

Q8: 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.

Yes

There is a wide range of information that can be used for representing, reporting and disclosing on intangibles. In particular, a rich array of indicators that are and can be utilized by companies are the aforementioned industry-based WICI-KPIs (www.wici-global.com/kpis/).

An interesting subdivision of these indicators would be between those related to the past (so called "past-to-present indicators") and those referring to the future (so called "present-to-future indicators"), as evidenced in the WICI Framework.

Furthermore, Integrated Reports and the Japanese Cabinet Office's Business Management Design Sheets are useful sources, as well as Chapter 4 of the "WICI Intangibles Reporting Framework".

Q9: 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?

For non-financial narrative to be included in financial reporting, utilization of Integrated Reporting, WICI Intangibles Reporting Framework and the above-mentioned Business Management Design Sheet can be useful.

Also WICI KPIs and the KPI Concept Paper on KPIs could be useful reference points (www.wici-global.com/kpis).