A summary of EFRAG's Discussion Paper *Better Information on Intangibles – Which is the best way to go?*

Background

1 EFRAG's Discussion Paper on intangibles has been prepared as part of EFRAG's project Better Information on Intangibles. Different approaches to obtain better information on intangibles are analysed, based on input from members of the EFRAG Advisory Panel on Intangibles. The Discussion Paper presents various alternatives and discusses their benefits and disadvantages without providing recommendations on the selection of a particular approach. The approaches presented address 'intangibles' with reference to intangible sources of possible economic benefits. This includes items that would not meet the definition of an asset in the IFRS literature. The Discussion Paper only considers information to be included in financial reports. The term 'financial report' is used to refer to the primary financial statements, including the notes, and a management report.

2 The approaches presented only deal with how to provide better information for intangibles that are used in an entity's operations (as opposed to those that are used as investment or for other purposes). The scope is also limited to cover only information that is useful for primary users of financial reports.

Issues with the current information

3 In order to provide approaches for better information on intangibles, EFRAG's Discussion Paper first lists perceived issues with the current information on intangibles provided in financial reports.

4 EFRAG's commissioned literature review, published in February 2020, identified academic studies showing that the value relevance of financial statements is decreasing and that this could be due to financial statements not reflecting information about intangibles, which has become more important for more entities than previously. Insufficient information on intangibles could affect the company's market value due to information asymmetry, result in an inefficient capital allocation in society and make assessment of the management's stewardship difficult.

5 The review also underlined the difficulty for users to compare entities that grow organically with those growing by means of acquisition, as current IFRS Standards generally require acquired intangibles to be recognised, while internally generated intangibles can only be recognised in specific circumstances.

6 The Discussion Paper also mentions that some are of the view that the performance figures resulting from IFRS are distorted as they do not consider internally generated intangibles when examining an entity's return on assets and because expenses related to internally generated intangibles are not reported in the period in which the resulting benefits are achieved.

7 Some consider that recognising more internally generated intangibles (and perhaps fewer intangible assets acquired in a business combination) would be a way to deal with the issue that internally generated intangibles are accounted differently from acquired intangibles. However, in this scenario, all recognised internally generated intangibles would have to be measured, and both measurement at cost and at fair value are problematic. In addition, not all intangibles would meet the definition of an asset.

8 Instead of recognising and measuring intangibles in the statement of financial position, additional disclosures could be considered to provide better information on intangibles. This alternative, however, also has some problems. Boundaries between different intangibles are not (well) defined and are interpreted differently. There are also no generally accepted ways on how to report on intangibles. Finally, additional information on intangibles may be commercially sensitive to provide.

Approaches for better information on intangibles

9 The Discussion Paper considers three approaches for better information on intangibles:

(a) Recognition and measurement in the primary financial statements;

(b) Information on specific intangibles in the notes to the financial statements or in the management report;

(c) Information on future-oriented expenses and risk/opportunity factors that may affect future performance in the notes to the financial statements or in the management report.

Recognition and measurement in the primary financial statements

10 Accounting for intangible assets under IFRS can result in otherwise similar intangible assets being accounted for differently depending on whether they are acquired or internally generated. Intangibles are generally recognised only if acquired, either separately (individually or as part of the purchase of a group of assets) or as part of a business combination. Internally generated intangibles, other than development costs, are therefore not generally recognised as assets in the financial statements even though they may be the most important intangibles for entities. Accordingly, both costs related to the income of the current period and costs related to gaining income in the future are recognised as expenses in the statement of financial performance.

11 This makes it difficult to compare IFRS financial statements of an entity that has built (or builds) up substantial intangibles internally, with those of another entity that has purchased most of its intangible assets. To some extent, alternative performance measures, currently provided voluntarily by some entities adjusting the results for the components of the purchase price allocation, attempt to facilitate the comparison of the financial performance of entities growing by acquisition with the performance of entities growing organically. However, relying on voluntary disclosures may not be the best way forward. In addition, those alternative performance measures would not enhance the comparability of the statements of financial position.

12 In order to enhance the comparability between entities that grow organically with entities that grow by acquisition, consideration could also be given to recognising fewer intangible assets separately from goodwill in a business combination. However, such an approach was not widely supported when the IASB recently consulted on this in its discussion paper *Business Combinations - Disclosures, Goodwill and Impairment*.

13 The Discussion Paper considers alternative recognition (and measurement) requirements to those currently applied. In considering the recognition and measurement of (internally generated) intangibles, three questions are addressed:

(a) Which type(s) of intangibles should be considered for recognition (and measurement)?

(b) Under which circumstances should such intangibles be recognised? and

(c) Which measurement basis or bases should be considered?

14 On the question of which intangibles should be considered for recognition, the Discussion Paper states that it would be a radical approach to recognise intangibles that are not controlled by an entity. For the remaining discussion about recognition and measurement, the Discussion Paper thus focuses on intangibles that meet the definition of an asset under the Conceptual Framework for Financial Reporting ('the Conceptual Framework').

15 The Discussion Paper presents four different approaches to recognition of intangible assets:

(a) an approach under which all intangible assets are generally recognised,

(b) a threshold for recognition (of an asset) approach under which intangible assets are recognised if certain criteria are met,

(c) a conditional recognition (of an asset) approach under which intangible assets are recognised when they meet certain criteria, and

(d) an approach under which no internally generated intangible assets are recognised.

Information relating to specific intangibles

16 The Discussion Paper also discusses proposals to require disclosures that can provide information on a specific intangible to help users of financial reports assess the contribution of that intangible to the value / the value creation of the entity. The benefits of recognising more internally generated intangibles may be questionable and may not outweigh the associated costs. An alternative would thus be to provide better disclosures on specific intangibles. Disclosures on specific intangibles could also supplement recognition of (some) internally generated intangibles.

17 The intangibles, for which the Discussion Paper would propose the provision of information, are those that are key to an entity's business model. Under the approach described in this chapter, when providing information relating to specific intangibles the first step would accordingly be to describe the entity's business model(s) and identify which intangibles are important for the entity's success following its business model(s).

18 Information relating to specific intangibles could be both qualitative and quantitative, or a mix of both.

19 Some of the advantages of information relating to specific intangibles would be that granular and detailed information, on the intangibles that are key to an entity, would be provided. The information could also be less subjective than recognising and/or measuring intangibles, less complex and hence less costly.

20 One of the disadvantages of this approach is that intangibles often create value with other intangibles and other assets. The most relevant disclosure may therefore sometimes not relate to a specific intangible. Also, the information would not provide a solution to the issue of distorted IFRS performance measures resulting from generally not recognising internally generated intangibles.

Information on future-oriented expenses and risk/opportunity factors that may affect future performance

21 The Discussion Paper discusses an approach under which further information is provided on the expenses recognised in a period together with information on risk/opportunity factors that may affect future performance. Under the current requirements, some of the expenses recognised in a period might be considered to relate to benefits that will be recorded in future periods. Information on these expenses could help users assess the performance of the current period and make

estimations of the performance in future periods. The Discussion Paper notes that information on future-oriented expenses can either be provided by:

(a) Providing more detailed information about the expenses recognised in a reporting period and to allow users of financial statements make their own assessments about the expenses that relate to the future; or

(b) Requiring the preparer of financial statements to state the amounts of expenses recognised in a period they consider relate to the future.

22 Information on risk and opportunity factors could also help users of financial reports when estimating future performance. Under the approach discussed in the Discussion Paper, it is considered that sufficient information on risk/opportunity factors that could affect the contribution of intangibles to the financial performance of an entity would generally be provided if entities disclose information on risk/opportunity factors that are material and specific to the entity.

23 One of the advantages of the approach to provide information on future-oriented expenses by disclosing more detailed information about expenses is that a fixed terminology to be used to distinguish between different intangibles is not necessary for providing information on the recognised expenses of a period. Also, as the approach is based on the combined effect on earnings at entity level, the approach caters for the fact that often intangibles do not create much value on a stand-alone basis but together with other intangibles and assets.

24 One of the disadvantages of the approach of providing information on future-oriented expenses is that information on the effectiveness of the investments is not reflected (and IFRS performance figures will still be distorted) and the information will thus not be so useful for assessing management's stewardship. However, other aspects of the management's stewardship will be provided by disclosing how the entity is dealing with risks and opportunity factors.

Challenges and issues for possible solutions

25 The Discussion Paper does not express any preferences on which of the above-mentioned methods, or on which combination of the above-mentioned methods, should be the way forward for providing better information on intangibles. Instead, the Discussion Paper asks for constituents' input on this. The Discussion Paper, however, states that when considering how to provide better information on intangibles, consideration should also be given to:

(a) whether it would be beneficial to establish a common terminology on intangibles;

(b) how to provide useful information but at the same time not require entities to disclose information that is commercially sensitive;

(c) where the information should be provided – in the financial statements (including the notes), in the management report, or somewhere else;

(d) ensuring that requirements on information to be provided would result in relevant and comparable information;

(e) whether the approach to providing information on intangibles could affect an entity's access to finance;

(f) whether some of the current requirements can be removed.