INTANGIBLES – A Positioning Paper

Introduction – an issue of academic and professional relevance

As the global economy has moved from manufacturing to service-based, there has been increasing focus on the intangible drivers of value within companies, and how these act as indicators of the future value of a business. At the same time, concerns have been voiced that financial statements are losing their relevance as they do not reflect many of these intangible elements. This is clearly an issue of importance for all players in the corporate reporting cycle – standard-setters, preparers, investors and academics.

In order to determine if and how financial reporting should change in relation to intangibles, it is important to consider the context and overall aims of financial reporting. Under the IASB’s Conceptual Framework, financial reporting has two main objectives - valuation and stewardship. Financial reporting provides financial information that is useful to existing and potential investors, lenders and other creditors in making decisions, including assessment of cashflows and assessment of stewardship. It is worth remembering that general purpose financial reports are not designed to show the value of a reporting entity (but provide information to enable investors to make their own assessment).

In that connection the front end of annual reports and non-financial reporting around intangibles appears key. The issue is not about reconciling net asset value and market capitalisation for companies, but rather how to provide information on a company’s intangible value drivers and how they support and impact the performance and sustainability of its business model. In essence, how to provide information on those factors which are core to the creation of current and future value, and report on how these are being maintained and developed to sustain innovation and value creation into the future.

In the context of the application of section 172 of the UK Companies Act and the consideration of a wider range of stakeholders, the term ‘value’ needs to be interpreted not just in financial terms, but also in the way in which those other stakeholders are impacted by the company’s operations.

This paper uses the term ‘intangibles’ to include a potentially wide range of assets and other factors which drive the creation of value in companies, whether or not they are currently recognised or reported in annual reports and financial statements.
1 What are Intangibles – Definition

In its simplest form, “Intangibles are non-physical resources which either alone or in conjunction with other tangible or intangible resources can generate a positive or negative effect on the value of an organisation in the short, medium and long term.” (WICI Intangible Reporting Framework definition)

The WICI Framework further sub-defines intangibles as organisational (such as business processes), human (e.g. employees competencies and skills) and relational capital (e.g. customer relationships).

As far as financial accounting is concerned, the IASB’s revised Conceptual Framework for Financial Reporting defines an asset as “a present economic resource controlled by the entity as a result of past events” and states that ‘an economic resource is a right that has the potential to produce economic benefits’.

IAS 38 defines intangible assets as follows: “An intangible asset is an identifiable non-monetary asset without physical substance. Such an asset is identifiable when it is separable, or when it arises from contractual or other legal rights. Separable assets can be sold, transferred, licensed, etc. Examples of intangible assets include computer software, licences, trademarks, patents, films, copyrights and import quotas. […]”

With regards to recognition, IAS 38 requires that expenditure for an intangible item is recognised as an expense unless the item meets the definition of an intangible asset and:

- it is probable that there will be future economic benefits from the asset, and
- the cost of the asset can be reliably measured.

The cost of generating an intangible asset internally is often difficult to distinguish from the cost of maintaining or enhancing the entity’s operations or goodwill. As a result, internally generated brands, publishing titles, customer data and similar items are not recognised as intangible assets. The costs of generating other internally generated intangible assets are classified into whether they arise in a research phase or a development phase. Research expenditure is always recognised as an expense, whilst development expenditure that meets specified criteria is initially recognised as an intangible asset. It should be noted that in practice however, companies are reluctant to capitalise development expenditure – the majority of R&D is expensed immediately with limited disclosure in the financial statements or narrative reporting, of what it related to.

As for the European System of Regional and National Accounts1 (ESA), this framework also provides a description of intangibles. ESA 210 replaced ‘intangible assets’ in ESA 95 by ‘intellectual property products’, and expanded the asset boundary to include the results of research and development. The framework includes a range of specific intangible assets, intended to be used for more than one year, as follows: research and development, mineral exploration and evaluation, computer software and databases, entertainment, literary or artistic originals and other intellectual property products. These sub-categories are further described in Appendix.

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1 The ESA is the system of national and regional accounts for members of the European Union, harmonising the methodology, concepts, definitions and classifications of accounting rules which are needed to enable a consistent, reliable and comparable statistical description of the economies of the member states and the Union itself.
2 The decline of the relevance of Accounting

The demise of the traditional accounting information and the importance of the ‘reporting gap’ relating to intangibles

The notion of intangibles and the ‘reporting gap’ arises from a belief, in some parts, that (1) intangibles have grown stratospherically in importance to drive the value of modern businesses, and that (2) the modern disconnect between the market value and net book value of a company can be largely explained by the company’s intangibles which are not reflected on the balance sheet.

Two diametrically opposed schools of thoughts have emerged: the need for increased recognition of intangibles in financial statements, chiefly by Baruch Lev, versus the belief that intangibles have always been a feature of modern societies and economies, and do not therefore require additional focus.

In practice, most people seem to sit in the middle of these two viewpoints. The majority of feedback to the UK Financial Reporting Council’s (FRC) recent Intangibles consultation highlights intangibles as a very important issue, where better quality reporting is needed to enable investors to understand value creation. However, feedback stresses that such reporting would not necessarily be through recognising more intangibles on the balance sheet, but rather through greater disclosure. Feedback from investors suggests that simply including additional intangible assets on the balance sheet would be given little credence.

Some academics, such as Douglas Skinner, believe that the reporting gap is overstated and that investors use alternative sources of information from the financial statements to adjust earnings and asset values for the accounting distortion resulting from the capitalisation of acquired intangibles vs. the expensing of a large proportion of internally generated intangibles - a distortion, according to Baruch Lev, which jeopardises the comparability of performance of peer companies solely based on an analysis of the financial statements, where one may favour a strategy of internally-generated innovation and the other may innovate through acquisition.

The case against a change in accounting for intangibles

Skinner (1) does not believe that mandating more extensive disclosures will be successful and (2) argues that proposals to modify the current accounting model to recognise intangibles on the balance sheet are flawed:

“Proposals for reforming accounting and disclosure practices in the intangibles area have been around for at least 15 years (dating at least to the origins of the Jenkins Committee) and accounting standard-setters have devoted considerable resources to this area. However, little actual progress has been made in terms of generating new accounting rules. I do not find this surprising. A close examination of claims made by those who advocate reform indicates that there is little evidence to support the notion that the current system has caused any serious problems for entities seeking to finance innovative, high-technology projects. In fact, I argue that financial markets work very well to finance these types of investments, although the way in which they are financed


3 D.J. Skinner (2008), Accounting for intangibles – a critical review of policy recommendations, Accounting and Business Research, 203

is naturally different from how tangible assets such as factories are financed. Moreover, I argue that proposals to mandate additional disclosure in the intangibles area are likely to be unsuccessful because of the fact that the nature and measurement of intangibles varies considerably across industries as well as for other reasons. I also argue that proposals to expand existing asset recognition criteria to include intangibles currently excluded from balance sheets are problematic in a number of respects. In the end, my view is that we need to rely on private incentives to encourage disclosure of information related to the management and valuation of intangibles, although regulators can help in this area by providing guidance about the forms that disclosure might take and by minimising any costs of disclosure, including legal costs.”

3 Intangibles: their significance and the quest for their measurement and disclosure in financial reporting

Are intangibles becoming more important?

As mentioned earlier, extant literature and opinion pieces generally argue that intangibles have stratospherically grown in importance as drivers of the value of modern businesses. A commonly quoted argument is that years ago when economies were more based on manufacturing and trade in goods, tangible assets were the primary driver of company value while intangible assets were a small component of corporate value largely thought of as reflecting the value of brands.

Dissenting views however exist, such as that from Basu and Waymire in a 2008 paper, as follows:

“We take a contrary perspective in this essay and assert that arguments favoring the expanded reporting of intangible asset values in balance sheets are flawed for three reasons. First, recent times are not unique in terms of the importance of intangibles. Indeed, intangibles are ubiquitous to human economic interaction and are present even in seemingly simple economies. Second, intangibles are ideas that build on other ideas to generate complementarities and synergies. The consequence of this is that the value of an individual idea typically cannot be discerned independently of other ideas, many of which are not owned by any given firm. Third, ideas are valuable only to the extent that they increase wealth or, in accounting parlance, give rise to income. Thus, emphasis on the balance sheet is itself misplaced, and a return to measuring income will likely serve financial statement users better than trying to value assets that by their fundamental nature cannot be independently valued.”

An anthropological perspective on different definitions of intangibles

Their overall conclusion is that “[...] Because economic intangibles are cumulative, synergistic, and frequently inseparable from other tangible assets and/or economic intangibles not owned by any single entity, it is usually futile to estimate a separate

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accounting value for individual intangibles. However, the income that intangibles together generate provides useful inputs for equity valuation, and voluntary non-financial disclosures could be informative for this purpose.”

The evidence on the book-to-market ratio for US companies, the weight of intangibles in their market capitalisation and its ‘correct interpretation’

Over the past two decades a number of academics, notably Baruch Lev again, have made the case that accounting information has declining relevance in valuing stocks, due to the rise in intangibles. In ‘The End of Accounting’ Lev states that while in 1950, net profit and equity explained over 90% of share price, by 2013 this proportion had fallen to around 50%.

Lev conjectures that the move from an income statement to balance sheet approach to accounting has been detrimental – that the expensing of intangibles instead of capitalising them results in poor matching of revenue and costs, therefore impacting the quality of earnings prediction.

Ocean Tomo, an intellectual capital consultancy, carried out analysis in 2017 showing the decline in the relevance of tangible assets to the market valuation of a company. Their figures for the S&P 500 show that in 1975, tangible assets accounted for 83% of market value, while by 2015 this figure had dropped to 16%.

There is a view that this gap is being overstated – whilst there may be specific issues for technology companies, many of the world’s leading companies operate traditional business models which are well understood by the market.

The Ocean Tomo view appears to presume that accounting information can provide an estimation of market value – though this is not the current objective of financial reporting. There are many factors outside the control of management that can influence market capitalisation, therefore the gap may not be fully explained by intangibles.

Investors are increasingly interested in corporates’ long-term strategy and value creation – and therefore in the intangible factors that companies have at their disposal, whether these are recognised as assets or not. Disclosures around recognised and unrecognised intangibles can act as a bridge between the financial statements and the key value drivers of a business. It is noted that technology firms trade at a premium to their book values. Could this suggest that investors already have access to information that enables them to value these firms?

4 The rise of non-financial information

The rise of non-financial (or extra-financial) information on intangibles and the associated questions

In recent years, there has been increasing focus on non-financial or ‘front-end’ reporting and the role this plays in effective communication with investors and other stakeholders. Non-financial reporting encompasses elements such as the business model, risks, KPIs and explanatory narrative on the financial statements. Many of the leading frameworks (e.g. UK strategic report, integrated reporting and IASB management commentary) take a business model-led approach, focusing on the value creation process. This provides the opportunity for entities to give more information on intangible value drivers, which may or may not be recognised on balance sheet. The requirements for and expectations of non-financial reporting have grown exponentially in a short period of time, and therefore companies are still experimenting and developing ways to provide this. Enhanced information about intangibles is undoubtedly key to providing a view on the long-term sustainability of business models.
5 Critical conceptual and practical issues on intangibles reporting and disclosure

The difficult relationship between intangibles and accounting standards

Assets are defined under the Conceptual Framework as present economic resources controlled by the entity. In order to be recognised in the financial statements, intangible assets must also meet additional criteria set out in IAS 38, namely an intangible asset must be identifiable i.e. separable – that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, or arises from contractual or other legal rights. Internally generated intangibles must meet even stricter criteria, meaning that only a small proportion of research and development costs are capitalised.

The recognition of intangibles is constrained chiefly by issues around control, and the reliability of measurement. Unless secured by legal means such as patents or licenses, it can be difficult for entities to demonstrate control of the economic resource arising from research and development, or other innovations. When looking at a broader concept of intangibles – items such as staff training, it is even harder to assess the ‘economic resource’ which is controlled by the entity. Even where control is established, the reliability of measurement can create problems, as the likely outcome of projects cannot be assessed with sufficient certainty and the attribution of specific future cash flows to intangible items – such as staff training for example again - would be very difficult.

It is generally accepted that these issues mean that it is unlikely that more intangibles can be recognised under the existing financial reporting framework. The question is therefore whether to re-visit the purpose and elements of financial reporting, to explore wider corporate reporting as a route to improve reporting of intangibles, or, as explored in the FRC’s discussion paper, to focus on disclosure around the expenditure on unrecognised intangibles.

The difficulty in identifying and reporting meaningful information on drivers of value

The front half of companies’ annual reports would seem to be the key location for additional information on those intangible assets and other factors which drive the creation of value and sustain that value creation process.

A number of critical considerations exist to determine what this additional information should contain, how it should be best disclosed and the incentives or dis-incentives for companies to disclose. These considerations include:

• Drivers of value are probably unique to each company and/or to each business model within the company;
• The need for root cause thinking to ascertain the ‘real’ drivers of value, thereby providing more meaningful information and avoiding standardised or boilerplate disclosures;
• To what extent commercial sensitivity may lead to reluctance within companies to disclose the ‘real’ drivers of value;
• How to measure and report on those drivers of current value in meaningful terms;
• How to report on those factors which drive disruptive innovation and invent new business models which can sustain the longer-term creation of value;
• How to report the extent to which management have maintained those drivers of value to sustain value creation into the future;
• How to report on those factors which underpin the creation or destruction of ‘value’ in the context of broader stakeholders, e.g., impacts on employees, on the environment, local community and broader society.
Auditing of non-financial information: challenges and opportunities for the accounting profession

The expression of an assurance opinion on new disclosures on intangibles and other drivers of value in the broadest sense, could be challenging for current external auditors. Consideration would need to be given to:

- The greater levels of judgement and uncertainty in the disclosures provided;
- How to obtain corroborative evidence to support the disclosures made;
- The application of materiality to such disclosures;
- The level of assurance which could be given, which would inevitably be less than a financial statement audit;
- How that assurance might be expressed, to be clear to the user.

6 Research on Intangibles

This paper only briefly outlines some of the extensive considerations and deliberations over intangibles, and the continuing inability to bring about consensus and consequent action from standard-setters. As a result, uncertainty remains for prepares, users and wider stakeholders on how to appropriately deal with intangibles.

To quote Baruch Lev once more, “So, who will trigger the urgently needed change? Having engaged in research my entire professional life, I naturally believe in the power of solid evidence to ultimately change people’s minds. I, therefore, conclude [...] with a proposed actionable research agenda on intangibles which will hopefully change hearts and minds”.

The European Financial Reporting Advisory Group (EFRAG)

Responses to a recent consultation by the European Financial Reporting Advisory Group (EFRAG) on their future research agenda, flagged intangibles as a key area requiring attention. As such, EFRAG have recently launched a project on ‘Better information on intangibles’.

The project aims to develop alternatives to provide more relevant information on intangible assets in financial reporting.

The aim of the project is not to change accounting requirements to align the reported equity carrying amount with the market value of the company. Rather, the aim is to:

- Understand how entities report on how they create, maintain and/or improve value;
- Understand how users consumes information on how entities create, maintain and/or improve value and the extent to which current reporting addresses their needs;
- Provide suggestions on how information about how an entity creates, maintains and/or improve value can be provided in financial reports in a manner that would be useful for decisions on providing resources to the entity.

The project is limited to information provided in financial statements, the notes accompanying financial statements and the management commentary. The project will consider recognition and measurement in financial statements and both quantitative and qualitative information provided in the notes to the financial statements and the management commentary.

When providing suggestions on how information can be provided, a panel of users and preparers will be consulted. The project will thus establish a dialogue between users and preparers to develop practical suggestions.
ICAS Call for Research on Intangibles

ICAS would be interested in supporting research on any of the matters discussed above. This could complement the research by EFRAG in looking not just in the context of financial reporting, but also broader narrative reporting, the reporting of KPIs, and wider corporate reporting (e.g. integrated reporting and management commentary).

For example, our interest includes, but is not limited to, research on the following research questions:

- How do companies identify their intangibles, drivers of value and factors that create future success? Are these sufficiently well linked to their business model(s)? What are the processes which companies follow?
- How are listed companies currently reporting on intangibles, drivers of value and factors that create future success, and how do they quantify or measure those intangibles?
- To what extent are these standardised or superficial, or genuinely the real drivers of future value? What are the constraints which might prevent quality disclosure of the real drivers of value?
- Basu and Waymire state that ‘the value of an individual idea typically cannot be discerned independently of other ideas, many of which are not owned by any given firm’. How do intangible-intensive companies identify, quantify and disclose such ideas as creators of value?
- Is company information on drivers of value useful to investors’ and other users in their assessment of companies’ future prospects, and how do they think this information can be improved?
- To what extent are investors and other users focusing on financial aspects of value vs. the creation and destruction of value to other stakeholders such as employees, environment and community/society?
- How important is assurance to investors and other users over information on intangibles, drivers of value and factors which create future success?

Other questions, such as those posed by Baruch Lev in his July 2018 paper⁶ can also be considered in guiding the research project definition. These can be summarised as follows:

- Why don’t companies engaging in research and development capitalise development costs more frequently? What are the costs and benefits of capitalisation?
- How do preparers measure and monitor the value and performance of intangible assets?
- What can information on acquired (capitalised) intangible assets tell us about valuing internally generated intangibles?
- How do auditors cope with auditing intangible assets and impairments and what are the implications for auditors of extending the reporting of intangibles in the annual report?

Further, the research may also look at ways to move forward on some of the proposals for improvements to reporting as identified from the FRC’s recent discussion paper.

The ICAS Research Centre provides research funding for policy-relevant impactful research. For further details please visit icas.com and search for ‘research funding’.

The Research Centre calls for applications for projects addressing the issues around

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Intangibles. ICAS welcomes all research methods, and the proposals must address the public interest and may include, but not be confined to, any of the issues discussed in this paper. Grant funding is available up to a maximum of £25,000 per project.

For clarity, the following topics are not within the scope of this call for research:
- Financial instruments;
- Goodwill; and
- Physical assets (including rights to use physical assets).

The final research report (maximum 10,000 words) arising from projects should draw conclusions and implications for policy makers, the accounting profession, regulators, investors and business. ICAS will use the reports to inform public debate and policy development and the projects will therefore be high profile. Authors will also be required to make short presentations of interim and key findings to ICAS. Further, a presentation of findings at ICAS sponsored events may also be required. Draft reports will be reviewed using practitioner and academic reviewers, with a view to publication and use by ICAS and to influence policy makers and practice. Publication in academic journals, following submission of the final report, is also encouraged.

If you are interested in undertaking a project in this area, please email enquiries@icas.com attaching a ‘call for research’ application form (available at icas.com) and a proposal together with summary CVs, by 30 September 2019. The Guidance Notes for Research Applicants (available at icas.com) explains what should be included in the proposal. Applications are not restricted to the academic community, and are accepted from around the globe.

The applications will be considered by the ICAS Research Panel to arrive at a final decision. Applicants will be advised of the decision by 17 October 2019.

For further information about this funding opportunity or any queries please contact the ICAS Research Centre at enquiries@icas.com.
APPENDIX

ESA 2010 - Intellectual Property Products

AN.117 Intellectual Property Products
Fixed assets that consist of the results of research and development, mineral exploration and evaluation, computer software and databases, entertainment, literary or artistic originals and other intellectual property products, as defined below, intended to be used for more than one year.

AN.1171 Research and Development
Consists of the value of expenditure on creative work undertaken on a systematic basis in order to increase the stock of knowledge, including knowledge of man, culture and society, and use of this stock of knowledge to devise new applications. The value is determined in terms of the economic benefits expected in the future. Unless the value can be reasonably estimated it is, by convention, valued as the sum of costs, including those of unsuccessful research and development. Research and development that will not provide a benefit to the owner is not classified as an asset and is instead recorded as intermediate consumption.

AN.1172 Mineral exploration and evaluation
The value of expenditure on exploration for petroleum and natural gas and for non-petroleum deposits and subsequent evaluation of the discoveries made. This expenditure includes pre-licence costs, licence and acquisition costs, appraisal costs and the costs of actual test drilling and boring, as well as the costs of aerial and other surveys, transportation costs, etc. incurred to make it possible to carry out the tests.

AN.11731 Computer software
Computer programs, program descriptions and supporting materials for both systems and applications software. Included are the initial development and subsequent extensions of software as well as acquisition of copies that are classified as AN.11731 assets.

AN.11732 Databases
Files of data organised to permit resource-effective access and use of the data. For databases created exclusively for own use the valuation is estimated by costs, which should exclude those for the database management system and the acquisition of the data.

AN.1174 Entertainment, literary or artistic originals
Original films, sound recordings, manuscripts, tapes, models, etc., on which drama performances, radio and television programmes, musical performances, sporting events, literary and artistic output, etc. are recorded or embodied. Included are works produced on own-account. In some cases, such as films, there may be multiple originals.

AN.1179 Other intellectual property products
New information, specialised knowledge, etc., not elsewhere classified, whose use in production is restricted to the units that have established ownership rights over them or to other units licensed by such units.
Please help inform our work on performance and provide your views on the questions raised in this paper and/or apply for funding to undertake research in this area.

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