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To whom it may concern,

Business Reporting of Intangibles: Realistic Proposals

We welcome the opportunity to respond to the Financial Reporting Council's consultation on the business reporting of intangibles.

The Quoted Companies Alliance *Financial Reporting Expert Group* has examined the proposals and advised on this response from the viewpoint of small and mid-size quoted companies. A list of Expert Group members can be found in Appendix A.

Overall, we welcome your work to improve the business reporting of intangibles. As the use of intangible assets has become more frequent and their standing more prominent, there is need to add further levels of clarity to the reporting of these assets.

At present, there is considerable uncertainty associated with the reporting of intangibles, namely in terms of their recognition and measurement. As such, when these assets are included in financial statements it often raises questions and causes confusion for the users of these accounts.

Small and mid-sized quoted companies are keen to improve on the business reporting of intangibles in order to ensure that they accurately convey reliable information to the users of their accounts. That said, any additional reporting requirements relating to intangible assets must take into consideration the additional costs and administrative burden that this may place on smaller companies, bearing in mind their more limited resources. Smaller companies should be encouraged, but not required, to report on intangible assets in their financial statements only when they believe it provides useful and necessary information for those who access their statements and when they have the capacity to do so, whereby it does not stymie their growth.

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

General comments

If the FRC is to enhance its credibility and maximise its influence during its transition into the Audit, Reporting and Governance Authority (ARGA), thought leadership projects are essential. That said, we believe that these projects should encourage responses from all users of accounts, and should not be effectively restricted solely to those who have a technical accounting background.

The purpose of a set of accounts is to communicate to users relevant and useful information, in an easy to use and understandable format. As the users of accounts are the prime audience, the success of any consultation depends on the overall quality of the responses from the users of accounts. The language used within this consultation is quite technical and some of the concepts could have been explained more clearly in order to encourage responses from those without a technical accounting background.

Any developments in financial reporting should be a user-led process, whereby companies are directly encouraged to adopt best practice. This follows Sir John Kingman's recommendation that ARGA should consider the needs of users rather than the preparers of financial information. However, and as highlighted by Kingman, any developments made within financial reporting must be proportional so that user requirements do not place a disproportionate burden on smaller companies and limit their growth.

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

We agree that it is important to improve the business reporting of intangibles. The nature of such assets included in financial statements often raises questions for users, including auditors and regulators, on the relevance of their recognition, the appropriateness of their measurement and continued recognition when external factors indicate a possible impairment to such assets.

The case to improve the business reporting of intangibles is particularly pertinent as technology becomes ever more prevalent and the potential number of intangibles is likely to increase markedly. For instance, cloud-based technology, which represents a shift away from the capitalisation of IT hardware and software, but still requires significant investment by companies.

In order to best improve the business reporting of intangibles, the project to do so should be conducted in co-ordination with the Financial Reporting Lab, and should take into consideration the views of small and mid-sized quoted companies. It is important that a consistent set of principles for recognition is established, even though the process to do so may be arduous due to the wide-ranging variation in underlying assets.

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

Intangibles should be recognised at the point in time the project meets the capitalisation criteria for development costs where it is an internally generated intangible asset. This avoids instances where costs have been estimated after the event and a correction put through the financial statements to recognise further costs when more information or resource has been identified.

They should only be recognised at cost when they can both be sold separately from the company, and their value can be measured reliably without the use of complex models. From the perspective of small and mid-sized quoted companies, it is important that the use of complex models is avoided due to the cost and administrative implications that this can place on smaller companies.

A reliable measure of the value of an intangible helps to provide clarity on appropriate methods of amortisation or monitoring for impairment. If there is a lack of clarity on how an intangible should be amortised, or assessed for impairment, then it is likely that the valuation method is not sufficiently reliable for recognition of an intangible as an asset.

Therefore, and due to conflicting opinion, we do not believe that the proposed conditions set out above in (i) add sufficient clarity for the recognition of an intangible at cost.

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

We agree with the assumptions that the paper makes regarding the measurement uncertainty associated with intangibles. Specifically, when companies use the fair value hierarchy under IFRS 13, it is likely that the intangibles will be measured under the Level 3 approach which is inherently uncertain and subject to a high degree of judgement and estimation. Using the Level 3 approach can bring into doubt the validity of the value calculated, especially when the disclosure of the method used is minimal or lacks sufficient clarity. For this reason, and under such circumstances, intangibles should not be recognised due to the significant levels of uncertainty in relation to the measurement of their value.

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

Yes. We agree that both UK FRS and IFRS need to be updated to improve the accounting of intangibles. Specifically, existing accounting standards need to be revisited in order to ensure that only appropriate intangible assets can be recognised. The main area for improvement in the reporting of intangibles lies in narrative reporting and outside the remit of accounting standards.

That said, the value of any changes should be clearly evidenced by the standard setters in determining the benefit from enhancing the accounting and disclosure of intangibles.

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

We agree that the disclosure of expenditure relating to intangibles would be helpful. However, we believe that the proposals relating to expenditure on intangibles would be difficult to produce for some entities and continue to be inherently subjective in nature. Furthermore, it is difficult to identify the direct benefit that would be derived from the proposed additional disclosures. This is especially the case for the proposed additional disclosures relating to expenditure incurred which does not meet the definition of an intangible asset, which would need to be material to warrant disclosure in the first place.

Companies who incur material expenditure on internally generated intangibles should disclose the extent of the expenditure as part of the explanation of their business model. The utility of such disclosure in narrative reports should be obvious so that it removes the need for accounting or reporting standards that specifically require such disclosure. The content in the annual report, which sets out the entity's business model, and the disclosures on the intangible assets capitalised in the financial statements, should be sufficient to enable users to determine the reason why costs have been expensed to the Income Statement during the year for a project where the capitalisation criteria are not met.

That said, levels of disclosure should vary dependent on the size of the company in question. Consideration should be given to smaller companies who have less readily available resources and may struggle with the additional administrative burdens associated with disclosing such information.

As well as this, the benefits of reporting a cumulative amount of future-oriented expenditure is not straightforward. Companies should only be encouraged to report on such information where they consider that it provides useful information to users of financial reports and where they have the capacity to do so, thereby not resulting in unnecessary cost or burden on them.

For this reason, the disclosure of expenditure relating to intangibles should not be a mandatory requirement. Rather, a set of guidelines should encourage companies to disclose information on expenditure on intangibles where it adds value to the users of the accounts.

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

We agree that improvements in narrative reporting in respect of intangibles is required, namely in those entities whose business model encapsulates such assets. However, the proposal to require metrics is not viewed as an efficient or effective method to improve such reporting. The proposal to require metrics adds a layer of complexity and compliance for small and mid-sized quoted companies who, rather than benefitting from further reporting requirements, would be better placed to improve their existing disclosures with more robust and detailed commentary on the use of intangible assets in their company.

Despite this, and whilst we agree with certain proposals aimed at improving the quality of information on recognised and unrecognised intangibles in narrative reporting, it is important to ensure that the front half of the accounts does not become overloaded with unnecessary information, which then causes pertinent information to be lost.

With regards to 10 (v), and despite believing that industry specific guidance around intangibles would improve comparability, we do not believe that it should be the role of the standard setter to standardise the definition and calculation of metrics within specific industries. Rather, the responsibility to do so should fall to users who should encourage such standardisation. Users can more effectively co-ordinate and highlight the issues directly with companies, or indirectly through industry bodies.

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?

There is a need for accounting standard setters to update accounting standards to prevent the recognition of intangibles that are not separately saleable and/or cannot be measured reliably. Moreover, there is significant room for improvement of narrative reporting on intangibles, something which is best effected by better quality of feedback from investors, either directly to companies, or indirectly through industry bodies or the Financial Reporting Lab.

Additional guidance can assist in helping achieve improvements in the reporting of intangibles. The challenge of issuing such guidance will be ensuring that all relevant participants are aware of, and use that guidance when preparing and reviewing financial statements and annual reports.

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.

We have no comment to make on this question.

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?

The fundamental purpose of financial reporting is to ensure the supply of accurate and reliable information to stakeholders and interested parties. Obtaining feedback from users of accounts and other stakeholders that identifies where companies are communicating effectively and highlights where there is room for improvement, is the most effective mechanism for extrapolating this information and improving financial reporting as a whole. One of the FRC's most important roles is in encouraging and disseminating such feedback, so that preparers of financial information can incorporate improvements in subsequent reports, or be reprimanded by their shareholders for not doing so.

In order to do so, clearer guidance on the existing narrative disclosure requirements expected in both the annual report and financial statements should be issued. This could include publishing a number of case studies to highlight examples of a range of good practice. Due to the continually evolving nature of best practice, a range of examples should be published, instead of a single best practice example. A FRC Thematic Review similar to that for the IFRS 9 and IFRS 15 would be useful to raise awareness and highlight the requirements as well as good disclosures.

<u>Appendix A</u>

The Quoted Companies Alliance *Financial Reporting Expert Group*

Matthew Howells (Chair)	Smith & Williamson LLP
Rochelle Duffy (Deputy Chair)	PKF Littlejohn LLP
Edward Beale	Western Selection PLC
Matthew Brazier	Invesco Asset Management Limited
Elisa Noble	BDO LLP
Anna Hicks	Saffery Champness LLP
Mark Hodgkins	Trackwise Designs PLC
Clive Lovett	Bilby PLC
Laura Mott	Haysmacintyre
Claire Needham	KPMG LLP
Matthew Stallabrass	Crowe UK LLP
Jon Wallis	Grant Thornton UK LLP
Peter Westaway	Deloitte LLP