



25th April 2019

Via email to: intangibles@frc.org.uk

Andrew Lennard
Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

Business Reporting of Intangibles: Realistic proposals

Dear Andrew,

This is a joint response from UKSA and ShareSoc on behalf of individual investors.

UKSA and ShareSoc represent the interests of private shareholders. In addition to our own members, there are 5 million people who own shares and have investment accounts with platforms in the UK. The Office for National Statistics estimates that individual investors own 12% of the UK stock market by value. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes.

We believe that the discussion paper is a valuable contribution to the debate about the reporting of intangibles. Numbers in brackets below refer to the relevant paragraph in the discussion paper. We agree that it is appropriate to review the reporting of intangibles. We agree with the definition of an asset (2.2) and the commentary on the problems of accurately valuing intangibles discussed in Section 2. We also agree that reporting on intangibles needs to focus on those that play a key role in the business model (4.5). It has to be added, however, that much so-called business model reporting remains poor or very poor. As such, it constitutes a weak foundation for more meaningful reporting on intangibles.

The main problems that we foresee in reporting on intangibles are those of providing information which:

- Is helpful to investors
- Passes the 'so-what?' test in terms of whether the information is useful.

Remuneration reports, for example, are loaded with information which is sometimes impenetrable, sometimes incomplete, sometimes misleading and often unenlightening to most investors. When it suits them, some companies like to plead commercial confidentiality as a justification for withholding information that would be very helpful to investors. We would not want to see a similar

outcome from changes to the reporting of intangibles. We discuss some of the problems that we foresee in our response to Q6 and the notes in the appendix to this question.

We have particular concerns about information on intangibles which it is suggested might form part of the narrative section of the annual report. This is currently unaudited. Much of the current content consists of management marketing puff, compliance boiler plate, obfuscation and patronising waffle¹. Whatever happens, more detailed reporting on intangibles should not fall prey to this.

Finally, **sound financial reporting is a basic prerequisite for good stewardship**. Whatever changes are finally agreed by the FRC and others for business reporting on intangibles, it will be important that a close watch is maintained on practical outcomes to ensure that the law of unintended consequences does not manifest itself.

Question 1. Do you agree that it is important to improve the business reporting of intangibles?

Yes – in principle. We recognise that intangibles have for many businesses become an important component of the factors which drive business success and future value. We have some concerns about the practical issues involved in reporting meaningfully on many intangibles.

Some intangible, such as leases for assets, can be often valued in a way that conforms to certain norms or principles. Although contentious with some investors, the new IFRS16 appears to be accepted as an improvement by many.

Other assets such as licenses, R&D expenditure, patents, promotional spend and (in particular) employee training are more difficult to pin down. A prescriptive approach to reporting on these is unlikely to be workable. Guidance setting out good practice might be helpful. We discuss this further in the response to Q6 below.

Question 2. Do you agree that an intangible should be recognised at cost under the two conditions set out above in (i)?

Yes.

Question 3. Do you agree with the assumptions the paper makes regarding measurement uncertainty of intangibles?

Yes.

¹ This is despite the 2015 FRC report on Clear and Concise Reporting which said, in relation to the new *introduction of the fair, balanced and understandable principle*, on page 3:

- **Companies are taking on board the objectives of the FRC's Clear & Concise initiative**
 - Investors highlight the importance of clear presentation of information.
 - The introduction of the fair, balanced and understandable principle has resulted in greater engagement from Boards in the annual reporting process.

Question 4. Do you agree that existing accounting standards should be revisited with the aim of improving the accounting for intangibles?

Yes. However, the starting point has to be one of identifying and defining what investors want to know. What should the new standards tell investors about investment in intangibles and how they should be valued? What caveats are required to ensure that investors are not misled – as clearly happened with the way in which certain elements of goodwill were accounted for by Carillion?

Question 5. Do you agree with the above proposals relating to expenditure on intangibles?

Yes; the proposals in Section 3 of the paper seem pragmatic.

Question 6. Do you agree with the proposals aimed at improving the quality of information on recognised and unrecognised intangibles in narrative reporting?

We agree that reporting should focus on those intangibles that are most relevant to the entity's business model (4.8). However, standards for business model reporting require improvement. Much business model reporting remains very poor. We also agree that many intangibles are probably best reported in the narrative section of the annual report (4.5). There are, however, a number of potential problems with this approach at present, including:

- The fact that the narrative section of the annual report is currently unaudited;
- The narrative section of the AR has become a repository for marketing 'puff' and boilerplate; most of this is unhelpful to investors who are trying to understand the business. It will be counter-productive if expenditure which is considered to be a key driver of business performance and future value is reported in a way that misleads and misrepresents.

We have commented further on these issues in the Appendix to this response with specific reference to:

- Licenses
- Patents
- Employee training and development.

The commentary in the appendix sets out in more detail the concerns we have about ensuring that reporting on intangibles provides sufficient information for investors to be able to understand and rely on what they are being told.

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?

We agree that further consideration is required as to how practice might be changed in future on the reporting of intangibles. In particular, investors need to be very clear about that they want and need to know.

There is then a debate to be had with preparers about the scope to provide this. The narrative section of most annual reports is already stuffed with information ('data' might be a better word)

which has been requested by regulators and others with the best of intentions but which, in practice, is often incomplete, indigestible, incomprehensible, misleading or simply of no value. Much of the information contained in many remuneration reports falls into one or more of these categories. Much environmental reporting comes a close second.

Serious work is required to improve the reporting of intangibles and a Reporting Lab project might be a good way to start.

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?

We, as private investors, would look to our own research to assess the impact of certain intangibles (R&D, new product development etc) on future revenue flows for a company. This research might be based on reports in the media and the press, talking to other investors (some of whom may have a background in the industry) and obtaining broker reports and other published research.

UKSA and ShareSoc also run company visits which allow members to meet and question senior management. Members may not always get all the information they want but such meetings are invariably highly informative and provide very useful insights into the company, its management, ethics and culture.

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?

Nothing that we have not already discussed above.

We would be happy to meet to discuss our response in detail.

Yours sincerely,

Peter Parry – Policy Director – UK Shareholders’ Association

Cliff Weight – Policy Director - UK Individual Shareholders’ Society

Appendix

Reference Q6 above:

Commentary on improving the quality of information on recognised and unrecognised intangibles in narrative reporting.

Examples of potential problems: Licenses

Consider the following two license agreements:

1. “Microsoft hereby grants upon payment in full a non-exclusive personal licence to use one copy of MS Windows 10 in object code form for the licensee’s internal business purposes only and in no other manner”.
2. “Microsoft hereby grants a perpetual exclusive licence to use modify test and copy together with rights to sub-licence an unlimited number of copies of MS Windows 10 in object and source code form for any purpose whatsoever”.

Clearly, these two license agreements are dramatically different in terms of their potential value. In a reporting situation investors need to be given enough information about a license to form a realistic judgement of what its value might be and whether management’s own valuation is justified. It may be that each of these two agreements should be valued at cost. However, this does not get us much further forward in terms of what investors really want to know about each or these two intangibles as drivers of current and future business value.

As the example above shows, licenses can vary enormously in terms of the restrictions placed on their use. The impact that this has on value can sometimes manifest itself in unexpected ways. Consider a situation in which a company (ABC Limited) has had a specific piece of software developed for it which gives it a unique edge in the marketplace. The value of the company in a takeover situation could be heavily influenced by the terms of the licensing agreement. If the license precludes transfer to or use by any other entity this will mean that the acquirer is unable to use and benefit from the software.

Suppose that the acquiring company puts a value of £250m on gaining access to ABC’s market management system and factors this into the offer price. If subsequent due diligence reveals that it cannot use the software it may reduce its offer by £250m or withdraw altogether. Of course, ABC could approach Supersoft and explore the possibility of changing the terms of the license. However, the price demanded by Supersoft could offset most of the gain that ABC’s owners hoped to make from the sale of the company.

While rare, similar real-life cases have arisen and do illustrate the problem of reporting meaningfully on the potential value of licenses as value-drivers for a business.

Potential Problems: Patents

We agree with the points raised in 2.19 about the problems of valuing patents. Essentially, it seems that it has to be up to investors to make their own judgements about value. The problem for investors is that information that companies provide about products in the narrative section of the Annual Report is usually designed to give a marketing gloss to their commercial potential rather than provide an accurate summary of the product’s prospects e.g.

“Our cancer treatment, *Oncol A*, passed Phase III clinical trials and went on sale late last year. This product is the result of a £150m research programme and is commercially well protected by patents around the world. We believe that it has the potential to gain a significant share of the global cancer therapy market which was estimated to be worth \$136 million in 2018 and is forecast to grow to \$211 million by 2024 – a compound annual growth rate of 8.4%”.

Again this only tells us a limited amount. It is reassuring to know that the product is protected by patents. It is useful to know that £150m was invested in product development; this may well be the amount to be capitalised or expensed in the financial statements. However, what investors really want to know is the realistic commercial potential of the product in a competitive market. What the company is not likely to say is that a competitor is in late Stage III trials with an even better and less expensive product which gets round all the patents taken out on *Oncol A* and that, far from achieving blockbuster sales, there is a real prospect that sales will fail to take off and that the associated research and development costs will have to be largely written off. Perhaps this should be in the risk report – although few are that specific.²

Thus the rigour applied to reporting in the narrative section of the AR will have to be tightened significantly if this is to be the place where much of the reporting about intangibles is to be provided.

A further problem in this area is that many companies refuse to give useful information on grounds of commercial sensitivity. This is already the case in some companies with the simple requirement to provide information about management performance targets. Smiths Group, for example, states:

‘As disclosed last year, the Committee will disclose annual bonus targets at such time as these are considered to be no longer commercially sensitive’. (Annual Report 2018 p105)

AstraZeneca states in its remuneration report:

‘The performance targets are currently considered to be commercially sensitive as prospective disclosure may prejudice the Company’s commercial interests.’ (Annual Report 2018 p132)

There is every prospect that reporting on intangibles, particularly those which are considered to be of key importance to the business, will be similarly circumspect and unhelpful.

This is not to be defeatist. It is simply to suggest that there is more to better reporting of intangibles than agreeing the basis of valuation (cost, income or fair-value), whether they should be capitalised and where they ought to appear in the annual report.

Investment in employee training and promotional activities

Many companies like to say that their employees are their most important ‘asset’. A corollary of this should be that the company believes in investing in its employees by providing regular training. This is, as the discussion paper points out (3.10), a ‘future-oriented expenditure’. It goes on to give a worked example of the cumulative amount of future oriented expenditure that might be presented in a note to the financial statements. However, what matters for investors is not only how much the company spent on training but what benefit was obtained from the expenditure or is expected to be obtained. All too often, money spent on training is wasted because inappropriate training is provided and / or is given to the wrong people. This is before we even begin to try to assess the effectiveness (in terms of commercial benefit to the organisation) of useful training given to employees who will apply it and benefit from it.

² This type of information is often available to investors via analyst reports and research reports. Such questions are routinely asked at meetings between the company and analysts and at meetings organised by UKSA and ShareSoc between companies and individual investors. Such information and the associated models of value that encompass them may be best suited to analyst reports rather than undertaken by auditors. What is important is that the annual report gives sufficient information that external analysts can use to feed into their models.

The same is true of expenditure on advertising and other promotional activities. As one marketing executive commented (perhaps apocryphally): “I know that half my advertising expenditure will be wasted. The problem is that I don’t know in advance which half”. Even for the portion of the advertising budget that was well-spent, it is very difficult to assess whether and when the anticipated benefits of the expenditure will actually accrue to the business.

Once again there is a real risk that information will be provided for its own sake and will be of little real benefit to investors. The key question, as always, must be: does the provision of this information pass the ‘So what?’ test?

Another comparison is with the oil industry where potential assets are described as Proven, Probable and Possible reserves³. Changes in these do not affect the P&L. However, there is a well-established methodology to calculate them and analysts, researchers and investors use the information in making their assessments of the value of assets.

³ Disregarding economics, the proper *engineering* term for the total technologically extractable amount is the [Producible fraction](#), which is easily confused with the *business term proven reserves*. However, the purely engineering term is also misleading in that squeezing the last bits of fossil fuel out follows the [diminishing returns](#) and at some point is so costly that it becomes highly impractical, as seen on a [bell curve](#), which is why measures like P90 and P95 were created. The term *proven reserves* is further subdivided into *proved developed reserves* and *proved undeveloped reserves*. Note that it does not include *Unproven reserves*, which is broken down into [probable reserves](#) as well as [possible reserves](#).

For further explanation see https://en.wikipedia.org/wiki/Proven_reserves