



Memo

To: Australian Accounting Standards Board

From: User Advisory Council of the Canadian Accounting Standards Board

Date: May 26, 2009

Re: **Internally Generated Intangible Assets**

The following comprises the response of the User Advisory Council (UAC) of the Canadian Accounting Standards Board (AcSB) to the Australian Accounting Standards Board's *Discussion Paper (DP) Initial Accounting for Internally Generated Intangible Assets*, dated October 2008.

The UAC comprises 24 members with diverse backgrounds as financial statement users, including investors and investment professionals, credit granters in financial institutions, equity and credit analysts, and rating agency analysts.

The views expressed in this memo are those of the UAC members and do not necessarily represent the views of the AcSB, its committees or staff, nor do the views expressed by the UAC members represent the views of their respective organizations.

We support the initiation of a project on internally generated intangible assets as intangible assets often represent a significant portion of an entity's value and, in some cases, can be an entity's most valuable assets. Furthermore, we support research in this area to resolve a

significant inconsistency within IFRSs — purchased intangible assets are recognized in the financial statements, while many internally generated intangible assets are not recognized. A resolution to this inconsistency would improve comparability between entities.

From our experience, we note that most debt analysts exclude intangible assets from their analysis, while equity analysts are more likely to see these assets as very important.

Identification

We believe that the manner in which an intangible asset comes into existence is not relevant to the determination of whether an item can be identified as an asset, i.e., it should not matter whether an item was internally generated, separately purchased, or acquired in a business combination. We cite an example of a large software company acquiring a small software company to obtain plug-in technology with features that would work well with its existing platform. The large company acquires the small company as it believes that it is cheaper to buy the company outright than develop the new technology in-house. Why should an asset be recognized in this scenario but not if the same software was developed internally?

A financial statement user estimates future cash flows and thus, focuses on the attributes of an asset, not on how it was acquired.

We agree that in identifying an internally generated intangible asset, no distinction should be made as to whether the item was planned or unplanned. For example, some entities develop innovative products/ideas on a regular basis. An entity may be headed in a particular direction as it develops a product/idea, however, the commercial value of its output may be completely different than expected or planned. Should it matter whether the product/idea was planned or not in justifying its identification as an internally generated intangible asset? 3M's invention of post-it-notes was an unplanned activity with substantial value that should have been identified as an internally generated intangible asset.

We believe that unidentified assets overstate earnings during an accounting period. For example, an entity that designs and manufactures an aircraft engine with more power, less weight, and consumes less fuel may invest a certain amount of time/energy/effort to develop a prototype of

such an engine. Under current accounting requirements, the costs incurred would likely be expensed as incurred. That prototype may become commercially viable and sales may begin in the next accounting period. At that time, revenue would be recognized, with expenses recognized in the previous period — a mismatch of revenue and expenses. Both revenue and yield would be overstated. A return on asset could not be determined as the asset would be missing from the equation.

Recognition

We believe that when an unplanned asset can be measured in a reliable manner, that asset should still be recognized. We do not see the planned vs unplanned distinction as the right criterion for recognition. In fact, we are confused by this distinction. We believe that the focus for recognition should be on whether the internally generated intangible asset can be measured in a reliable manner and to consider the following questions:

- (a) Are the costs reasonably identifiable? and
- (b) Can the costs be allocated in a reasonable manner?

We note, however, that Canadian entities allocate costs by project to claim an investment tax credit for corporate income tax purposes.

We explain the practical reality of allocating costs to three different projects with different risk profiles. It is not known at the start of these projects whether all or certain ones will be successful. Most entities invest many dollars in research and development, but write-off their project costs as an expense in the early stages as the definition of an asset is not met. We believe that an intangible asset should be recognized as soon as management sees its potential for generating income or cash flows, whether it was planned or not. We emphasize the need for specific criteria to clearly delineate the point of discovery, i.e., when does an internally generated intangible asset (planned or unplanned) become recognized as an asset?

We discussed the effect on an entity's financial statements when a project's costs are written off and it is subsequently discovered that that project has value. For example, an employee may

tinker in an entity's basement for three years performing general research. During those early development years, an asset may not be identified and thus, costs are not identified. Let's assume that at the end of the third year, the entity sees the potential of that employee's tinkering. Most of us suggest that the entity should recognize costs as an asset from that point of discovery and onwards, i.e., as soon as management sees the project's potential for generating income or cash flows. We believe that missing some early costs is not critical from a measurement perspective as early costs are often only a small part of the total costs of a project. We recognize the difficulty in determining the point of initial recognition as it can take many years to develop a product.

We believe that all internally generated intangible assets should be recognized whether internally generated, separately purchased, or acquired in a business combination. If all internally generated intangible assets can be recognized in a business combination, we do not see any difficulty in recognizing these assets outside a business combination.

Measurement

We hold mixed views on the appropriate measurement basis.

A majority clearly favour a fair value approach with multiple methodologies — a cost-based approach to fair value is used during the early stages of development; then once the process/product progresses, a greater weight is placed on a more reliable income approach as the assumptions are refined or qualified; and to ultimately a market approach when transaction evidence becomes available.

A minority, on the other hand, express concerns about the subjectivity of fair value and the potential or likelihood of management bias. They prefer a cost-based model at all stages of development other than for certain types of internally generated intangible assets in which such a model might be problematic to use as a result of measurement issues eg customer lists and brands. They emphasize the practicality of a cost-based model with cost as a reliable measurement basis.

We note that lenders eliminate the value of all internally generated intangible assets from the balance sheet, and thus, the choice of model would make no difference to them.

Presentation/disclosure

We suggest the following additional disclosure requirements, if a cost-based model were adopted:

- The future benefit expected from internally generated intangible assets, even if not quantified such as a general statement to provide some insight into management's expectations as to its future benefit; and
- The vintage year(s) that costs are incurred¹. This information may be in the form of a table indicating that, for example, in 1985, 20% of the costs were incurred; 1989 20% of the costs etc. An analyst could then step back and see, for example, that 75% of the costs were spent 15 years ago or more. Depending on the nature of the asset, this information may imply that the asset would cost substantially more to develop internally today. It was noted that this information helps an analyst in identifying arbitrage opportunities.

We disagree with the proposal to disclose “if an internally generated intangible asset does not meet the relevant recognition criteria, ... entities should be required to disclose ... why the asset fails to meet the relevant recognition criteria” (paragraph 240). When an entity does not recognize an internally generated intangible asset, the asset does not meet the recognition criteria — period. We agree that meaningful disclosures include expenditures on research programs by type of research with amounts capitalized, amounts expensed and cash outflows, but we believe that it is a stretch to disclose how many expenditures were close calls.

We also have some additional comments on disclosure/presentation, including:

- If changes in an assumption do not have a significant effect on a conclusion, that assumption cannot be a significant assumption; and

¹ This disclosure suggestion applies to accounting in subsequent periods.

- Disclosure of a significant assumption implies disclosure of the parts of the value model without actually disclosing the model. We express concern that if the assumption is disclosed, explicit details are not disclosed about the model.

We note that the Discussion Paper's conclusions on presentation/disclosure do not address the geography of the information, i.e., whether the information should be in the notes to the financial statements or on the face of the financial statements.

Overall, we believe that accounting for intangible assets is an importance issue and encourage you to move forward with this project to resolve inconsistencies within the current model and improve comparability between entities.

We would be pleased to elaborate on these points in more detail if you require. If so, please contact Blair Carey, User Advisory Council Vice-Chair, + 1 416 601-2270 (email blair@thirdeyecapital.com), Mark Walsh, Principal, Canadian Accounting Standards Board at +1 416 204-3453 (e-mail mark.walsh@cica.ca), or Nancy Estey, Principal, Canadian Accounting Standards Board at +1 416 204-3271 (e-mail nancy.estey@cica.ca).