



Accounting Standards Board

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Dear Robert

Discussion Paper 'Initial Accounting for Internally Generated Intangible Assets'

This letter sets out the comments of the UK Accounting Standards Board (ASB) on the above Australian Accounting Standards Board (AASB) Discussion Paper (DP).

The ASB welcomes the work of the AASB in the area of reporting intangible assets. However, given everything else on the international standard setting agenda and the lack of demonstrated user need for this information, we do not consider further work a top priority at present. If there is to be further work undertaken, it should consider:

- a more detailed evaluation of all the benefits and costs associated with reporting additional internally generated intangible assets including the potential that preparers of financial statements will incur high costs with no demonstrated benefit to users;
- an investigation into the practical aspects of reporting internally generated intangibles – we acknowledge the AASB has taken a conceptual approach, but what is appealing from a conceptual perspective may not be feasible from a 'front-line' perspective;

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- an expansion of the scope of the project beyond initial recognition. We understand your need to keep the scope of the paper at a manageable level but we find it very difficult to consider an initial accounting treatment without analysis of subsequent issues; and
- a more gradual approach to recognition of additional intangibles (assuming there is evidence of user need for this information). We consider that a single accounting treatment for such wide and varied group of assets may not be feasible and would encourage further discussion based on specific types of intangible assets, for example, those assets listed in paragraph 33 of the paper.

The paper does not present a compelling case to support its primary conclusion that internally generated intangible assets be recognised at fair value at each reporting date. In particular, we do not agree with the presumption in IFRS 3 that assets acquired in a business combination can always be reliably measured if they are 'separable or arise from contractual or other legal rights'. In our view then, this presumption would also be inappropriate for internally generated intangibles.

More detailed comments regarding the specific arguments and conclusions made in the paper are provided in the Appendix to this letter.

If you would like to discuss these comments, please contact Melanie Kerr (020 7492 2428, m.kerr@frc-asb.org.uk) or me.

Yours sincerely



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Appendix

Response to the Invitation to Comment

Meeting user needs

1. We acknowledge your concern regarding the anomaly between reporting internally generated and externally acquired intangibles and agree that further research is necessary to examine whether it is reasonably possible to resolve this anomaly. However, we do not agree with the assumption that the best way to correct this anomaly is necessarily through the recognition of additional internally generated intangible assets. Before reaching a conclusion on the best way to correct this anomaly, we consider that a more thorough understanding of the information needs of financial report users is required.
2. Given that existing evidence, discussed in paragraphs 23-24 of the DP, regarding the decision usefulness of recognition and measurement of intangible assets is at best mixed, we would like to see a more thorough attempt to engage the users of financial statements in further research. For example, by conducting more interviews.
3. We agree with your point that standard setters need to consider the needs of both unsophisticated and sophisticated users. However, we do not necessarily agree that additional information on internally generated intangible assets will be of use to unsophisticated users, especially if this information adds to the overall complexity of the financial statements.
4. The UK Financial Reporting Council (FRC) has recently completed a research project on complexity in corporate reporting.¹ The existing requirements for valuation of intangibles were described as complex by both users and preparers and the draft discussion paper for the complexity research project notes the following:

.....during interviews most users mentioned that they do not consider valuation of intangible assets acquired in a business combination useful. Preparers note that valuing intangible assets is complex, theoretical and time consuming; and they do not use this information internally when making acquisition decisions. In addition, academic research confirms that valuation of intangible assets is one of the most time consuming areas in the audit process.² So preparers are spending lots of time preparing – and taking through audit – information that users do not find helpful. A more proportionate requirement might be a disclosure that uses the same information that management uses internally to make acquisition decisions.

¹ The FRC plans to publish a discussion paper containing the results of its complexity research in April/May 2009. The research team engaged with 151 preparers and 56 users during the course of the project.

² Beattie, Vivien A. , Stella Fearnley and Tony Hines DRAFT An Analysis of Financial Statement Issues Reported as Discussed and Negotiated by Key Preparer-Side Groups in UK Listed Companies in the First and Second Years of IFRS Implementation (2009).

Recognition and measurement of internally generated intangibles at cost

5. We agree that measuring internally generated intangible assets at cost is feasible and the more difficult issue is determining the appropriate point at which to start recognising these costs as an asset. It is not apparent to us that recognising intangible assets when they become ‘planned’ will be an improvement over the current requirement for ‘technical feasibility’ to be demonstrated prior to recognition.
6. Paragraph 86 of the DP notes that ‘reluctance to recognise certain internally generated intangible assets in a cost-based model reflects a view that different recognition criteria from tangible assets are warranted. However, we also do not think that, conceptually, there is a technical basis for such a view.’ We consider that this paragraph implies an arbitrary tangible/intangible asset split in IFRS. We consider that the increased uncertainty surrounding the future benefits of an intangible asset, especially at the early stages of development, may provide enough justification for a more robust set of criteria for recognising an intangible asset than for recognising a tangible asset.
7. We agree with paragraph 85 that earlier recognition of intangibles will result in a greater number of impairment charges, which will ‘clutter the financial statements without adding to their information value’. Further, we are particularly concerned with the implication in paragraph 78 that intangible assets should be recognised (and immediately impaired if necessary) when they meet the definition of an asset through the existence of gross future economic benefits. We consider that the cost of this exercise clearly outweighs the benefits and it will add greatly to the complexity of the financial statements.
8. We do not consider that the planned and unplanned distinction is useful for the purposes of developing an accounting standard. In practice, we do not believe it possible to create a robust definition that will enable all intangibles to be split neatly into these two groups. We also echo the concern expressed in the paper that the planned and unplanned distinction is too heavily dependent on process. We wonder whether discussion of this dichotomy is necessary or useful for recognition of intangible assets at cost. In our view, the costs of recognising intangible assets can either be reliably measured or they cannot – there is no need for a planned/unplanned split.

Recognition and measurement of internally generated intangibles at fair value

9. We are concerned that this paper uses the fair value precedent set under IFRS 3 to justify extending the use of the fair value principle in IFRS. In our view, extended use of the fair value principle should be debated during the measurement phase (phase C) of the Conceptual Framework Project and not introduced via the IFRS 3 precedent.

10. The paper argues that since IFRS 3 makes the presumption that intangible assets acquired in a business combination can be reliably measured if they are 'separable or arise from contractual or other legal rights' that this is also appropriate for internally generated intangible assets.
11. We disagree with the presumption made in IFRS 3. In our October 2005 response to *Exposure Drafts of Proposed Amendments to IFRS 3* we noted that:

We do not believe that you can reliably measure all intangible assets. In the absence of an active market, valuation will be based on estimated future cash flows. Whilst it might be possible to estimate the cash flows arising from the business combination, requiring these cash flows to be disaggregated to individual assets can only be done on an arbitrary basis.

An example of an intangible asset that arises from a legal or contractual right that cannot be sold and where the cash flows are inextricably linked with the cash flows that the business generates as a whole is a customer list which exists in a regulated market. The ability to sell the customer list is prohibited or rendered ineffective by prohibitions on cold calling.

12. Preparers interviewed for the purposes of the FRC's complexity project further echoed this point. They said that in making their acquisition decisions they value the business as a whole – subsequent allocation of the purchase price to intangible assets is theoretical and arbitrary.
13. We consider the IFRS 3 presumption is even less appropriate in the case of internally generated intangible assets, when there is no business combination to provide some realistic boundaries on the valuation.
14. We are concerned with the conclusion at paragraph 113, which proposes recognition of intangible assets under a valuation model using a hypothetical business combination technique. We consider that this will be extremely costly to apply in practice and has the potential to yield unreliable measurements that do not reflect the reality of the business. Given the very large number of assumptions and estimations needed to account for an imaginary business combination, we are concerned that the ability of users to compare financial statements between different entities would be made worse under this approach, instead of better.
15. The scope limitation to initiation recognition and measurement allows the paper to bypass some very serious practical issues with the proposal to fair value internally generated intangible assets at each reporting date. Specifically:
 - i. How often can internally generated intangibles realistically be valued given cost benefit considerations? How will the recommendations impact, say, quarterly reporting?
 - ii. Does an expert need to be involved in all instances?

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- iii. How will goodwill be separated from other intangibles in a reliable way if intangible assets are valued each reporting period using a hypothetical business combination methodology?
16. The discussion in paragraphs 181 to 185 outlines some very significant obstacles to the recognition and measurement of internally generated intangibles at fair value. We question, in light of these concerns, how the paper is able to conclude that ‘internally generated intangible assets should be required to be initially measured at fair value to enhance the decision-usefulness of financial reports’. We are especially concerned that the paper is not able to make a compelling argument that reporting more internally generated intangible assets at fair value will in fact increase the decision-usefulness of financial statements.

Disclosure of internally generated intangible assets

17. We continue to support the disclosure of intangibles as part of the narrative reporting produced by companies. We note that whilst a disclosure only solution may not be optimal, it does allow companies to communicate the nature of their intangibles and the uncertainty associated with their measurement more effectively than a single number in the balance sheet.