

American Accounting Association Financial Accounting Standards Committee

**Response to the FASB Invitation to Comment on the Proposal for a New Agenda Project -
"Disclosure of Information About Intangible Assets Not Recognized in Financial Statements"**

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Preamble

The Financial Accounting Standards Committee of the American Accounting Association (hereafter, the Committee) is charged with responding to requests for input from standard-setters on financial reporting issues. The Committee is pleased to respond to the FASB's invitation to comment on the Proposal for a New Agenda Project – Disclosure of Information About Intangible Assets Not Recognized in Financial Statements (hereafter, the Proposal). The opinions in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

Scope of this letter

This letter speaks to the issues raised in the Proposal specifically. In particular, we note that this letter is a precursor to a more-comprehensive letter on intangibles by the Committee that will summarize and evaluate the relatively large literature on this topic and that will focus on issues related to recognition and measurement, as well as disclosure. We expect to submit this letter to the Board before our annual meeting with the Board next May.

General comments

The Committee is broadly supportive of the FASB's proposal for considering issues related to the disclosure and recognition of intangibles. In particular, we agree with the general notion that there are currently inconsistencies in the accounting treatment of economically similar intangibles; for example, the difference between the treatment of intangibles acquired externally and those developed internally. However, we have some reservations and other comments about the Proposal as it currently stands, which fall into the following areas:

1. Disclosure approach.
2. FASB agenda criteria.
3. Pertinent research evidence.

1. Disclosure approach

The Committee has some concerns about the general premise of the Proposal to mandate the footnote disclosures of certain information regarding intangibles. These concerns may be summarized as follows.

In our view, the current Proposal does not provide a convincing case that the proposed disclosures have net benefits to capital market participants or other users of financial statements. Instead, the Proposal

simply asserts a popular (in the financial press and among certain commentators) argument that: (1) the current financial reporting and disclosure regime for intangibles is somehow deficient, and (2) the proposed mandated disclosures will correct this deficiency.¹ In our view, these arguments are neither clearly laid out nor supported by convincing evidence.

We have little evidence that speaks to the benefits and costs of disclosures on intangibles. If the FASB is to step in and (say) mandate the disclosure of certain information on intangibles, a question that seems relevant is: why have firms chosen not to disclose this information voluntarily?² One answer is that there are likely to be costs associated with such disclosures, including both costs associated with measuring intangibles and proprietary costs of disclosing such information to competitors. Another answer may be that the benefits of these disclosures are not very large, perhaps because these disclosures are not very informative to investors due to low relevance or imprecise measurement. Whatever the case, it seems to us that the relatively low levels of voluntary disclosure in the intangibles area raise the possibility that disclosures in this area do not provide net benefits. In other words, we are concerned that the document seems to proceed on the assumption that the current “approach is suboptimal” (p. 2). Our preliminary contention is that we know little, in terms of evidence, about whether the current disclosure environment for intangibles is “suboptimal” and how mandated disclosures would correct this apparent market failure.³ We would therefore encourage the FASB to investigate the costs and benefits of intangibles disclosures further, rather than assuming that mandated disclosures in this area provide net benefits.

The Proposal advocates a “disclosure” approach but indicates that this could be a first step towards the recognition of intangible assets in financial statements. We have concerns about how this process – moving from a disclosure regime to a recognition regime – is expected to work. One rationale for such an approach is that by allowing preparers to experiment, through disclosure, with the measurement of certain intangibles, preparers will have time to resolve measurement issues. However, this suggests that initial footnote disclosures on intangibles will have considerable measurement error, which may lead users to view intangible disclosures as relatively uninformative. Additionally, disclosure of information on intangibles may lead users to interpret this information differently precisely because it is footnote information and so indicated to be less reliable (e.g., Bernard and Schipper 1994). Perhaps the Board can consider its own experience in the area of accounting for derivative securities where the Board also started out with a disclosure approach (in SFAS-105, SFAS-107, and SFAS-119) before ultimately arriving at a final statement dealing with recognition (SFAS-133). Looking back, what were the advantages and disadvantages of this approach, and in particular, did the experience gained with the early disclosure statements help resolve the subsequent recognition issues? Is there any part of this experience that can be used to help inform the Board on how best to proceed in the area of intangibles?

If information is to be disclosed, perhaps it should be limited to information that can be reliably measured and verified by auditors. At page 5, the Proposal lists four possible types of disclosures, which we briefly comment on in turn.

- Major classes of intangible assets and their characteristics. How would “major” classes be defined? Would this be a firm or industry level determination (here we could envision issues arising analogous

¹ For example, on p. 1 the Proposal asserts that one of the principal goals of the project would be to “improve the quality of information currently being provided—information vital to well-reasoned investment and credit resource allocation decisions.” We are not aware of specific arguments or evidence that suggests that current resource allocation decisions in the economy are suboptimal or of evidence on how the proposed disclosures would “fix” this problem.

² This is documented in the recent Steering Committee Report of the Business Reporting Research Project, “Improving Business Reporting: Insights into Enhancing Voluntary Disclosures” (FASB, 2001).

³ For a general discussion of market failures in the context of accounting information, see Leftwich (1980).

to those in the segment reporting area – firms might choose to define disclosure classes so broadly that the disclosures might become meaningless)? On the other hand, if flexibility is not permitted (the FASB defines these classes), how will the rules reflect the diversity that we observe across firms and industries in terms of the nature of the intangibles that are important? That is, we question whether a “one size fits all” disclosure policy is feasible in the area of intangibles given substantial diversity in the economic nature of intangible assets across firms and industries. Moreover, the Conceptual Framework provides limited guidance to resolve these disclosure issues, a point we return to below.

- Expenditures to develop and maintain intangibles. Since expenditures can be measured reliably and verified, it seems that providing more detailed disaggregation than currently available in the financial statements may be informative to investors. However, deciding how to disaggregate expenditures is problematic if there are difficulties in deciding on, say, how the major classes of intangibles would be determined. Additionally, requiring such disaggregation raises issues of consistency in the sense that perhaps finer disclosures in other areas of financial reporting should be required as well.
- Values of intangible assets. We have little evidence on how precisely the values of intangible assets can be measured, especially since the nature of many intangibles is such that they are difficult to value on a stand-alone basis. As Lev (2001, Ch. 2) indicates, intangibles are characterized by a lack of well-defined property rights, “spillover” effects, etc., which leads in turn to a lack of well-established secondary markets for intangibles. These factors suggest that the measurement issues related to the valuation of intangibles will be substantial. Again, we are reminded of recent experiences in the area of financial instruments where non-trivial measurement issues arise with certain financial assets (and liabilities) that have fairly well-defined, agreed upon, and contractable cash flows. We suspect that valuation issues related to intangibles will be substantially more difficult to resolve than those already encountered in the area of financial instruments, and so are dubious about the reliability of information pertaining to the value of intangibles.
- Significant events that change the anticipated future benefits arising from intangible assets. How precisely would “significant” be defined here? Would it be defined in general across all intangible assets, or for individual classes of intangibles? If “significant” means that an event has occurred that has caused a material (in the legal sense) change in the value of an asset, is this provision not redundant with the SEC disclosure rules and securities laws?

2. FASB Agenda Criteria

Regarding whether this project satisfies the four FASB agenda criteria (p. 6), we question whether criterion (c) – technical feasibility – is satisfied. As the document indicates, the Conceptual Framework provides only general guidance about disclosure issues, and so it is unclear how the Board will resolve issues related to the disclosure of intangibles information without some type of framework. In particular, we can envision that, in developing a standard on the disclosure of information about intangibles, the FASB will have to decide among: (a) alternative pieces of information to disclose, and (b) alternative ways of disclosing that information. Without a stated framework for making such choices, it is unclear how the Board will proceed – what decision criteria will be used? If these types of decisions cannot be made, it would seem more likely that the resulting disclosure statement will leave these issues up to preparers to decide, which will give them the ability, if they so choose, to make fairly vague and uninformative disclosures.

We also believe there may be an issue related to criterion (d) – practical consequences. In particular, one piece of “evidence” cited by proponents of the need to provide more information regarding intangibles was the large and increasing difference between many firms’ market capitalization and book values, a trend that became especially apparent during the 1990s. For example, it was not uncommon for firms in the high-technology sector to have market-to-book ratios in the double-digits during the internet “boom”

years of 1998 and 1999. Some interpreted these ratios as evidence of the importance of a new business model in which intangible assets such as intellectual capital had become a key “value driver” for these firms. The fact that stock prices, especially those in the high tech sector, have declined fairly steadily since the early part of last year may reduce the persuasive power of these types of arguments, lessening the risk of any potential intervention by either the SEC or Congress. Moreover, the relatively high levels of stock market volatility evident over the last 2-3 years also speaks to concerns about the wisdom of using stock market prices as a benchmark for assessing the relevance of reported book values.

3. Pertinent Research Evidence

We are concerned that the proponents of the document are accepting popular arguments at face value, without consideration of the evidence. For example, consider the statement (p. 6) that “financial reports continue to fail to provide information about what many argue are increasingly the main drivers of values in the capital markets.” We are not aware of any specific arguments or evidence that supports statements such as this.

In addition, the proposal indicates that “(t)he substantial body of research by Professor Baruch Lev of New York University and others...should be of considerable interest in resolving the principal issues in this project (p. 4).” As indicated above, we plan to provide a fuller review of academic research in the intangibles area in a subsequent letter, but think it is relevant to indicate two points regarding intangibles research here. First, the Proposal takes the position that the supposed deficiencies in the area of financial reporting for intangibles can be “fixed” by providing additional footnote disclosures. However, the research referred to, by Professor Lev and others, does not directly speak to the issue of the benefits and costs of disclosure. Second, much of the research in this area uses the “value relevance” methodology. As Holthausen and Watts (2001) have recently discussed, these studies have recognized limitations, especially in terms of their applicability to standard-setting. For example, these studies tend to assume that equity market participants are the preeminent users of financial statement information, and sometimes ignore the need for financial information to be reliable and hence verifiable. Moreover, these studies have recognized methodological limitations that become more pronounced when applied to assets, such as intangibles, that are difficult to trade and which earn economic “rents.”

Several academic studies address the general topic of whether financial statement information has become more or less “relevant” through time (measured as the extent of the association between stock prices and financial statement information).⁴ Although the findings in this area are not completely consistent, it would be hard to reach a conclusion from this research that the relevance of financial statement information in general has declined through time.

Conclusion

To summarize our position, the Committee supports the spirit of the Board's proposal to initiate a project related to the disclosure and possible recognition of intangibles. Our concerns arise in the area of how best to go about this process. As we indicate in this letter, it seems to us that there are some difficult issues that the Board will have to address in implementing even the apparently simple task of increasing the amount of information disclosed about intangibles.

⁴ Three representative studies are Collins, Maydew, and Weiss (1997), Francis and Schipper (1999), Brown, Lo, and Lys (1999).

References

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