Chapter 1: Intangible Assets (including Research and Development)

Invitation to Comment: Agenda Consultation

Private Company Council
December 2016

FINANCIAL ACCOUNTING STANDARDS BOARD

Background

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- Included in the Agenda ITC based on feedback from the FASAC Survey
- Stakeholders have diverse responses to:
  - Which intangibles meet the definition of an asset?
  - If intangible assets were to be recognized, how should they be measured?
  - Would recognition of intangible assets:
    - Provide useful information to investors?
    - Have associated financial reporting benefits that justify the costs?

Internally Generated Intangible “Assets”

- Under Topic 350, Goodwill and Other, the costs of internally developing, maintaining, or restoring ***intangible assets*** (including goodwill) that are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an entity as a whole, are ***recognized as expense when incurred***
  - ***No overarching recognition and measurement guidance***
  - ***Industry specific guidance***
    - Software
    - Oil and gas industry

Internally Generated Intangible “Assets”

- Examples of **unrecognized** internally generated intangibles that are commonly asserted as assets include:
  - Research and development (R&D)
  - Noncompetition agreements
  - Goodwill
  - Brands and logos
  - Customer lists
  - Data

Research & Development

- In concluding that all R&D costs be charged to expense when incurred, Board members considered the following factors (FASB Statement No. 2, *Accounting for Research and Development Costs*):
  - The future benefits are at best uncertain
  - There is normally little, if any, direct relationship between the amount of R&D expenditures and the amount of resulting future benefits to the entity
- Total R&D expenditures for the period is a required disclosure

Acquired Intangible Assets

- Accounting for acquired intangible assets is diverse based on:
  - The manner of acquisition (asset purchase or business combination)
  - The type of reporting entity (public, private, not-for-profit)

IFRS – Intangible Assets

- The IASB requires recognition of intangible assets on the balance sheet at cost if the following criteria are met (IAS 38, *Intangible Assets*):
  - The intangible is identifiable
  - It is probable that the asset has expected future benefits for the entity
  - The cost of the asset can be measured reliably

IFRS – Research & Development

- The IASB makes a distinction between accounting for research and development, as follows (IAS 38):
  - **Research:** No intangible asset arising from research should be recognized. Expenditure on research should be recognized as an expense when it is incurred.
  - **Development:** An intangible asset arising from development should be recognized on the balance sheet, *at cost,* if, and only if, an entity can demonstrate all of the following:
    - The technical feasibility of completing the intangible asset so that it will be available for sale
    - Its intention to complete the intangible asset and use or sell it
    - Its ability to use or sell the intangible asset
    - How the intangible asset will generate probable future economic benefits (for example, the existence of a market or the usefulness of the intangible asset)
    - The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset
    - Its ability to measure reliably the expenditure attributable to the intangible asset during its development

FASB 2001 Special Report

- The Board completed a research project led by Wayne Upton that concluded with the publication of a 2001 Special Report, “Business and Financial Reporting Challenges in the New Economy”
- Because of a “new economy”, financial statement users need more information about intangible assets
- However, there are two “gaps” that frustrate attempts to recognize intangible assets in financial statements
  - *The time gap*: The period of time between R&D being incurred relative to when those expenditures and efforts can be demonstrated to have probable future benefits is undeterminable
  - *The correlation gap*: The cost of R&D is not a reliable measure of the future economic benefit that R&D may generate

FASB's Previous Standard Setting

- **2002:** A project was added to the Board's agenda with the goal of *providing financial statement users with more information about R&D costs through disclosure*
- **2004:** R&D was removed from the Board's agenda
- **2006:** R&D was listed as a topic for short-term convergence in the Memorandum of Understanding between IASB and FASB

FASAC Survey

- Identified as a top priority for the FASB's future agenda by **users** and **academics**
- Survey respondents stated the following concerns
  - There is no overarching framework, which creates inconsistencies and a lack of comparability for similar intangible assets
  - The accounting needs to be simplified and potentially converged with IFRS
  - Financial statements are incomplete because they are missing information

Potential Standard Setting Alternatives

- **Alternative A:** Recognize at cost or fair value internally generated intangible assets
- **Alternative B:** Recognize at cost or fair value research and/or development costs
- **Alternative C:** Disclose internally generated intangible items
- **Alternative D:** Adopt IAS 38

Scope

- Which intangible items should be recognized?
- When should they be recognized (for example, after a specified threshold is met)?
  - Apply the software capitalization guidance from Topic 985, Software
  - Adopt the IFRS intangible asset capitalization criteria within IAS 38
  - Create new capitalization criteria

Measurement

- How should intangible assets be initially and subsequently measured? Which measurement would be the most reliable and useful?
  - **Cost**
    - How should the balance be amortized and impaired?
  - **Fair value at every reporting date**
    - Where should the changes in fair value be recognized?

Feedback from Comment Letters on ITC

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Major Financial Reporting Issue?

31 of **44** total respondents addressed **intangibles**

58%

of those respondents listed intangibles as a **higher priority (first or second)**

- 20% of all 44 respondents listed intangibles as their first priority
- Accounting needs to be "modernized"
- Enterprise value of some companies are driven almost entirely by items that are not recorded on their balance sheets
- Inconsistencies between acquired intangible assets and internally generated intangible assets needs to be addressed

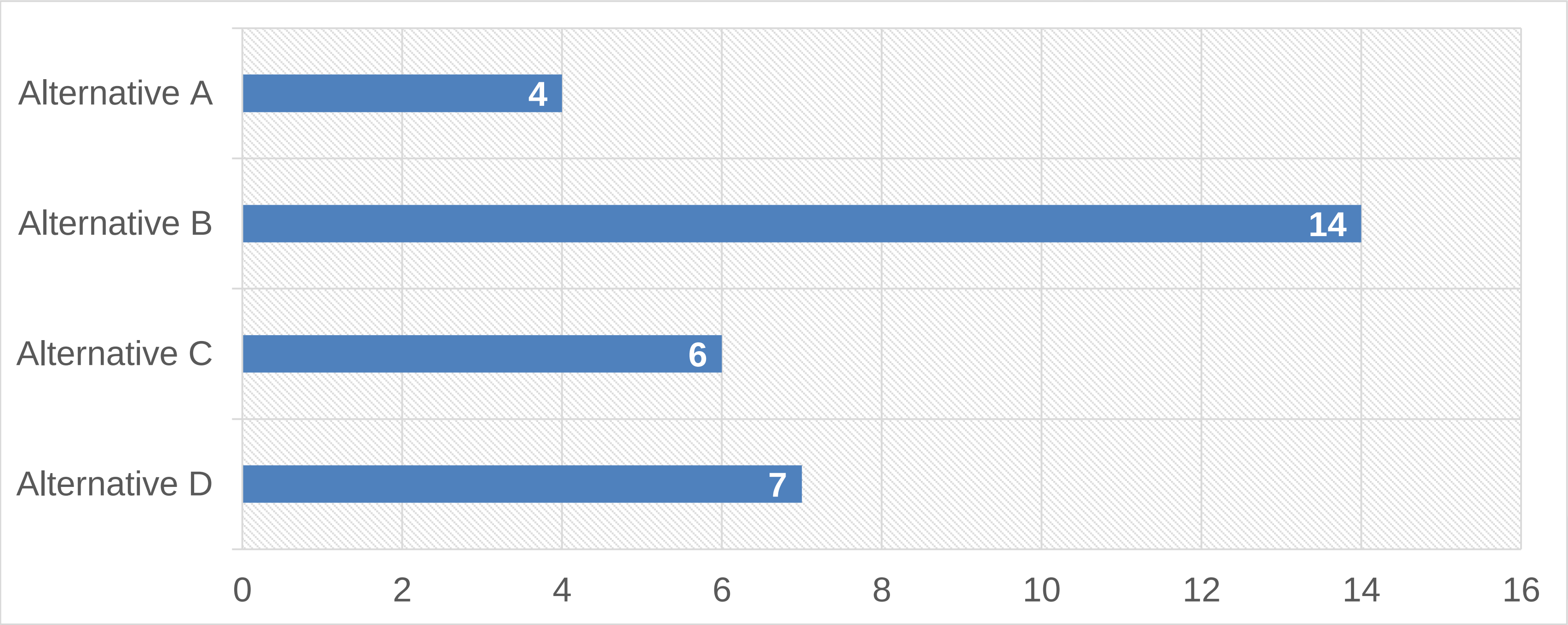
42%

of those respondents listed intangibles as a **lower priority (third or fourth)**

- Current accounting is reasonable and well understood
- Improvements could be made (for example, reduce inconsistencies) but other areas are a higher priority
- Concerns over relevance and reliability of measurements if more intangible assets were to be recognized on the balance sheet under the alternatives
- Alternatives would not be improvements to current guidance and the benefits would not outweigh the costs

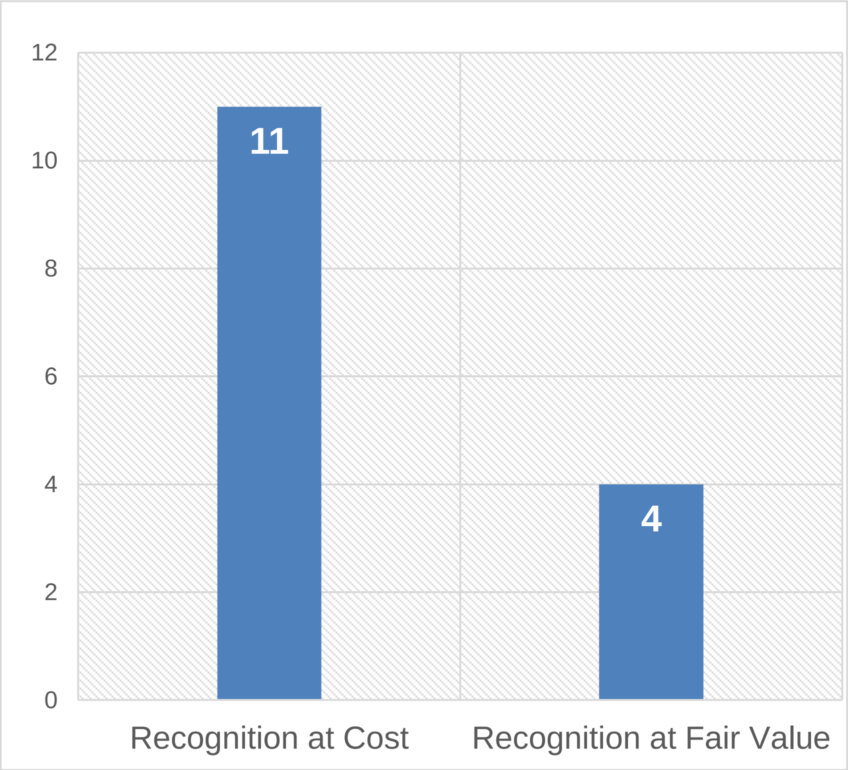
Recognition or Disclosure?

- Recognition of **research and development** costs has the **most support**
  - While seven respondents support IAS 38 to increase convergence, most respondents do not support adopting IAS 38 due to the subjectivity and high threshold
- The majority of respondents did **not support a disclosure approach** because they do not think disclosures would add value beyond what is already required to be disclosed



Recognition at Cost or Fair Value?

- Of those respondents who addressed the measurement question, most preferred **cost**
- Two users and two accounting firms supported **fair value**



Questions

- Is the accounting for intangible assets (including research and development) a **major financial reporting issue** that the FASB should consider for improvement?
- If yes, should the issue be addressed **broadly** for all intangible assets or should it first be addressed for a **subset** of intangibles (for example, research and development)?
- **Which approach** to addressing the issue is appropriate, considering the benefits and costs of each approach and why?
  - If you recommend a **recognition approach**, please explain your view about (a) the threshold for recognizing the asset and (b) the measurement of the asset (cost or fair value).
  - If you recommend a **disclosure approach**, please explain the disclosure objective and recommend what specific information should be disclosed.
  - If you recommend an **approach to adopt IAS 38**, please explain any implementation concerns.