The challenge of intangibles

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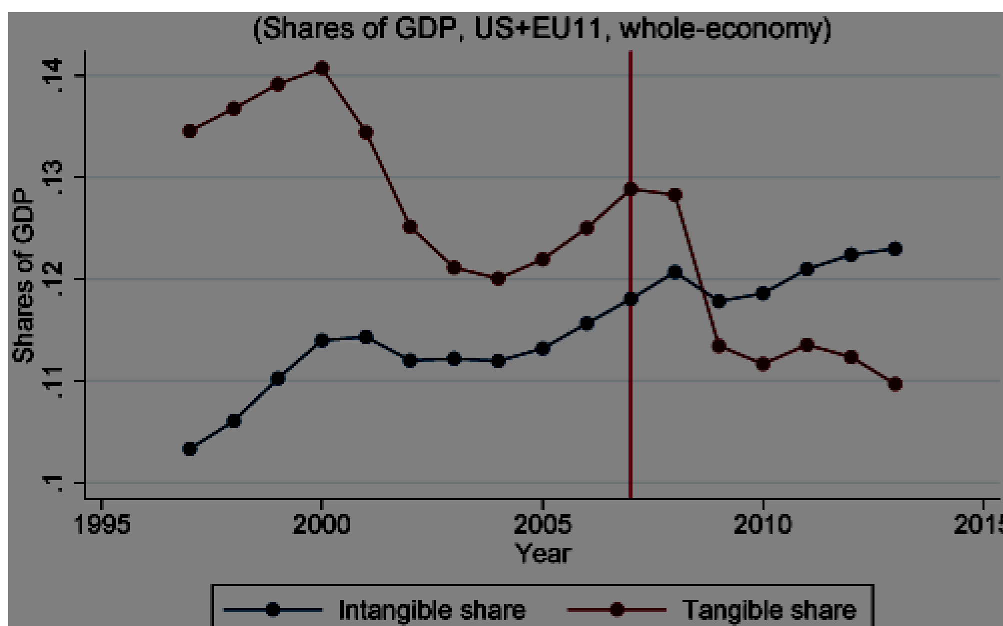
The importance of investment in intangible assets – such as software, R&D, design, branding, training, and business process engineering – for developed economies is well known. A recent article by Jonathan Haskel and Stian Westlake[1] shows that by 2013, for every £1 of investment in tangible assets (buildings, machines, vehicles, etc.) the major developed countries spend £1.10 on intangible assets.



Note: GDP adjusted to include intangibles

[1] "Productivity and secular stagnation in the intangible economy," 31 May 2018. See https://voxeu.org/article/productivity-and-secular-stagnation-intangible-economy.

Similarly, a discussion paper published by the European Commission in 2017 illustrates explicitly what is implicit in the previous figures, namely that investment in intangible assets has been growing faster than investment in tangibles in both the EU and the US since at least the mid-1990s. "Over the past two decades, the volume of annual GFCF in intellectual property products increased by 130% in the US and 87% in the EU-28. By comparison, the volume of tangible non-residential investments in the US stands at 70% above the level of 1995 and increased by only 30% in the EU." (p. 12)[2]

There is a general presumption that investment in intangibles is a good thing, in the sense that it is thought to be associated with innovation and, hopefully, an increase in total factor productivity that boosts GDP growth. On this basis at least, Europe is not doing so well. As pointed out in the Commission's Annual Growth Survey for 2019 (published in November 2018), over the last two decades, total factor productivity in both the EU and the euro area has lagged behind major global competitors. Interestingly for this audience, "intangible assets" merit only one explicit mention in the Commission's Annual Growth Survey 2019.

Intangible assets bring well-known measurement problems at both the macro- and the micro-economic level. The above-mentioned discussion paper pointed out that "[t]he System of National Accounts captures only about half of the total investment in intangible assets and also corporate financial reports provide only limited information on companies' investments in intangibles."

In what follows, I will focus on the micro-economic dimension, with a focus on the treatment of intangibles in corporate reporting – a term within which I include both financial and non-financial (or narrative, extra-financial, pre-financial...) reporting. In the short time remaining, I will quickly wrestle with three questions

[2] Thum-Thysen et al., "Unlocking Investment in Intangible Assets," European Economy Discussion Paper 047, May 2017. See https://europa.eu/!dJ49YV.

- What are the challenges of reporting about intangible assets?
- What are the consequences of current shortcomings in reporting about intangible assets?
- What can be done to address any negative consequences stemming from these shortcomings?

I will start with financial reporting. The most important intangible asset on many companies' balance sheets is goodwill. I will resist the temptation to start a religious war about the merits of amortising goodwill or about the effectiveness of testing goodwill for impairment. While I am not an accountant, I must nevertheless confess to being somewhat skeptical about the concept of goodwill, which sounds suspiciously like "how much did I overpay for this acquisition." This is of course a simplification and many with far more accounting expertise than me have strongly held views about the validity of goodwill as an accounting concept.

If we move away from goodwill, there is a long running debate about the 'intangibles gap' which may – according to some commentators – (partly or even largely) explain the gap between market values and book values. I am not the first to note that there are good reasons to avoid a dogmatic adherence to this argument. First, the purpose of financial statements is not to provide a business valuation. Second, the difficulty of identifying and valuing some types of intangible assets means that they are unlikely ever to be capitalised on the balance sheet.

There is nevertheless some force in the claim that accounting for intangibles is "a bit of a muddle" to borrow a phrase from an article published on the website of the ACCA not that long ago.[3] This is true both at a conceptual level and at a practical level. For example, is the different treatment of internally generated intangible assets pursuant to IAS 38 and of those acquired via a business combination pursuant to IFRS 3 conceptually sound? Furthermore, there is some evidence that the

[3] Richard Martin, "Reporting on intangibles is all a bit of a muddle," CPD Technical Article, ACCA. See https://bit.ly/2WMAOjE.

rules on expensing versus capitalising research and development are not applied consistently in practice. To quote the ACCA article again: "The indications are that many companies that should capitalise do not do so, and that some of those that do should not." As the ACCA notes, the fact that many companies expense the vast majority of their R&D suggests that the latter adds no value, which is counterintuitive.

I am generally skeptical about claims that changing accounting standards can solve difficult economic and even political (or at east policy) challenges. I have already noted that the market to book gap is unlikely ever to be fully eliminated by recognising more intangible assets on the balance sheet. Similarly, I remain to be convinced that recognising more intangibles is always a viable way to boost access to finance of innovative companies, in particular via collateralised bank lending. Partly for the reason discussed previously, i.e. the non-separability of some intangibles or the difficulty of valuing them with a sufficient degree of certainty means that some (many, most?) intangibles are not good candidates for recognition on the balance sheet in the first place. Moreover, even if they were recognised, I am not convinced that accounting valuations could always be used in the context of collateralised lending. This is because accounting valuations are derived on a going concern basis, whereas a credit risk manager of a lender must consider the possibility that such assets may have to be sold when the borrower is no longer a going concern, e.g. in insolvency and winding-up.

Nevertheless, we should be alert to the possibility that accounting standards could have unintended or even undesirable consequences. For example, does the fact that accounting standards permit the recognition of intangibles acquired via a business combination but not of internally generated intangibles create perverse incentives for empire-building CEOs? This question seems particularly relevant in light of the fact that the economic literature is at best ambivalent about the economic efficiency of mergers and acquisitions.

Differences in accounting standards (or in the way they are applied) from one jurisdiction to another may also undermine the level playing field for global competitors. For example, intangible assets are fully deducted from the regulatory capital of banks under the Basel Accord (implemented in the EU via the Capital Requirements Directive and Regulation). Whether a particular type of asset, such as software, is classed as a tangible or intangible asset, therefore impacts regulatory capital requirements. This is an increasingly important question in light of the IT revolution the banking sector is undergoing.

In short, accounting for intangibles is clearly perfectible. Accounting rules can have important economic effects through behavioural changes or regulatory interactions, including in relation to accounting for intangibles. However, improving accounting for intangibles is unlikely to offer a magic to achieve broader economic or policy objectives.

I will turn now to narrative reporting, also variously referred to as non-financial or extra-financial reporting among other terms. If, as discussed above, intangible assets play an increasingly important role in the economy but company balance sheets cannot capture a significant proportion of intangible assets, it seems logical to enquire whether narrative reporting could provide investors and other users with decision-relevant information about intangible assets.

WICI's Intangibles Reporting Framework is an interesting reference point. I am struck by the similarities between some of the principles of this framework and many of the issues we are currently considering in view of a possible future revision of the Non-Financial Reporting Directive (NFRD). First, there is a focus on the value-creation proposition of the company, including in the longer term. This necessarily means that narrative reporting must contain an important forward-looking dimension. This presents us with an immediate contrast with financial reporting, which is

essentially backward looking and confirmatory (even if accounting standards can also cover some important forward-looking issues, such as the new Expected Credit Losses in IFRS 9 on financial instruments.)

Peter Drucker is credited with two of the most important quotes in business management, one of which is that “If you can’t measure it, you can’t improve it.” This is self-evidently true. However, it would be a mistake to conclude that the only issues that matter are those that can be quantified. Quantitative KPIs can play a role but qualitative disclosures about business models, strategies, policies, risks and opportunities are at the heart of reporting about both intangibles and sustainability. And yet the information reported about these aspects of the business must still be reliable, relevant and comparable. Not an easy task. Clearly, there is still much to do to develop a comprehensive framework or standard to ensure that investors and other users of corporate reports receive information about these aspects of companies that meet such qualitative criteria. I expect that this will be one of the key issues we will need to grapple with if and when we propose a revision of the NFRD.

Does this mean that company reports will become even longer than they already are? Perhaps, although the worst possible outcome would be management reports containing reams of boilerplate disclosures (and lots of glossy pictures of course). However, I wonder for how long we will continue to think about the product of corporate reporting as a “report.” Investors, but also other users such as civil society organisations, increasingy demand structured information and data. The use of structured data standards and taxonomies to tag both qualitative and quantitative information may render the concept of a “report” irrelevant. Structured data standards and taxonomies should allow users to identify and analyse relevant information faster and through more powerful applications. These could include Big Data analytic tools and methods. Some large investment managers are already some way down this route.

The EU has already decided to use a structured data standard and taxonomy for financial reports of IFRS issuers of securities traded on EU regulated markets. I expect that this will only be a first step. Ten years from now, the idea of disclosing company information in paper or pdf format is likely to be considered hopelessly old-fashioned and obsolete. In principle, I see no reason why narrative, non-financial, ESG… reporting should escape this trend. And if a computer can almost instantly identify the text describing the environmental risks or opportunities a company has disclosed, does the size of the "report" (in fact a digital file) really matter? The advent of technologies such as 5G and quantum computing will transform the way we produce, transmit, store and consume information. The next ten years will be interesting in the field of corporate reporting.

Thank you.

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