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Non-paper of the Commission services on the CSRD proposal - Intangibles

DISCLAIMER

This non-paper has not been adopted or endorsed by the Commission. Any views expressed in it may not in any circumstances be regarded as stating an official position of the Commission. The information contained therein is only intended for discussions with the Member State representatives at the Council Working Party.

1. Introduction

This non-paper aims at supporting the discussions on the proposal for a Corporate Sustainability Reporting Directive, by explaining the reasons for the inclusion of the requirement to disclose information about intangibles.

Investment in intangibles today represents the majority of private sector investment in advanced economies. The European Economy Discussion Paper *Unlocking Investment in Intangible Assets* states that investments in intangible assets tend to be underestimated. The 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. The discussion paper also argues that future growth in advanced economies is assumed to be increasingly dependent on productivity-raising innovation.[1]

Therefore it is important that relevant information on intangibles is available. EFRAG has published a Discussion Paper on reporting on intangibles where it confirms that 'insufficient information on intangibles could affect the company's market value due to information asymmetry, *resulting* in an inefficient capital allocation in society and *making* the assessment of the management's stewardship difficult'.[2]

<u>2. Reporting requirement in the CSRD</u>

A. <u>Information gap</u>

There is broad consensus that information about intangible resources is under-reported. The Commission services are of the view that there are current gaps in corporate reporting requirements: undertakings are only required to provide information about intangible resources that are assets recognised in the balance sheet, and only limited to figures, with no explanation about how these intangible assets affect the undertaking's business model.

EFRAG in its Discussion Paper on Intangibles, recognises this problem and suggests that 'instead of recognising and measuring intangibles in the statement of financial position, additional disclosures

[1] European Economy Discussion Paper, *Unlocking Investment in Intangible Assets*

[2] EFRAG, Discussion Paper, *Better information on intangibles – which is the best way to go?*

could be considered to provide better information on intangibles'. The European Economy Discussion Paper *Unlocking Investment in Intangible Assets also defends that* 'other improvements of the mechanisms to disclose information on intangible assets in corporate reporting could be narrative reporting as put forward for instance by the OECD (2012)'.[3]

Additional information is needed both about how the business model depends on other intangible resources that are not recognised assets, that are not under the control of the company in the sense that they cannot be 'owned' (e.g. human capital[4]), about how the business model is dependent on intangible assets recognised in the balance sheet, beyond the provision of figures in the balance sheet, and how all these are a source of creation, preservation or erosion of the value of the undertaking. As an example, information on how the undertaking's business model is dependent on 'intellectual capital' may include information about intellectual property, such as patents, copyrights, software, rights and licences (in which case, in addition to these disclosures on dependency, figures will be provided in financial statements), and may include information about organizational, knowledge-based intangibles, such as tacit knowledge, systems, procedures and protocols (in which case, no additional figures will be provided in financial statements). It is equally important for investors and other stakeholders to understand how the undertaking's business model fundamentally depends on all these key intangible resources.

Intangible assets recognised in the balance sheet, are defined in IAS38. First, IAS38 (para 9) defines an asset as a resource: i) controlled by an entity as a result of past events; and ii) which future economic benefits are expected to flow to the entity. Second, IAS38 defines intangible assets as an *identifiable non-monetary asset without physical substance*. It also refers to classes of intangible assets for disclosure purposes, such as brand names, licenses and franchises, and copyrights, and sets recognition criteria for intangible assets to be included in the balance sheet and their subsequent measurement (amortisation) based on their useful life and residual value.

Therefore, IAS38 contains only disclosure requirements for classes of intangible assets recognised in the undertaking's balance sheet, and does not refer to information about other intangible resources (i.e. social and relationship capital[5]). The disclosure requirements under IAS38 on intangible assets mainly relate to information about useful life, amortisation and the reconciliation of carrying amounts from the beginning to the end of the reporting period, etc. Disclosures do not cover the dependency of the business model on these intangible assets.

[3] The Discussion Paper *Business Reporting of Intangibles: Realistic proposals* of the UK Financial Reporting Council, also recognises this problem and puts forward solutions explaining how narrative reporting might usefully complement the information provided in financial statements, both as regards recognised and unrecognised intangibles. It explains the focus of this narrative reporting should be on those intangibles that are most relevant to the undertaking's business model (value creation), including both those that are reported in the financial statements and those that are not

[4] Frameworks like the IIRC and the WICI in its Intangibles Reporting Framework Consultation Draft, refer to 'human capital', which covers the value that the employees of an undertaking provide through the application of their skills, competences, knowledge and loyalty to the undertaking.

[5] Frameworks like the IIRC and the WICI in its Intangibles Reporting Framework Consultation Draft, refer to 'social and relationship capital', which includes information on intangibles associated with the brand and reputation that an organization has developed.

IAS1 *Presentation of Financial Statements* addresses notes to the financial statements, such as the description of significant financial accounting policies and additional narrative descriptions or dis-aggregations of certain items in the financial statements for their better understanding.

In summary, under IAS38 or IAS1, there are: i) no disclosures that address how dependant the undertaking's business model is on those intangible assets recognised in the undertaking's balance sheet or how these are a source of creation, preservation or erosion of the value of the undertaking; and ii) no disclosures about how the undertaking's business model depends on other intangible resources or how these are a source of creation, preservation or erosion of the value of the undertaking (e.g. human capital).

The **disclosure objective** of the CSRD on intangibles is to make available information that enables investors and other stakeholders to understand the key intangible resources on which the undertaking's business model fundamentally depend, and which are a source of creation, preservation or erosion of the value of the undertaking.

In order to understand the importance of intangible resources for the business model, it should not matter if these intangible resources are recognised as intangible assets under the applicable financial accounting framework or not. Therefore, in its proposal the Commission has not excluded from the reporting obligations information as regards the dependency of the business model on this particular category of intangible resources (intangible assets) or the contribution of these intangible resources to the creation of value of the undertaking.[6]

B. Intangibles as reporting area in the CSRD

There are three main reasons for proposing the inclusion of intangibles as a reporting area under Article 19a/29a of the Accounting Directive.

First, there is a link between some information on intangible resources and sustainability matters. Certain information on intangible resources and sustainability matters could almost certainly overlap, for example in areas such as social or governance matters (e.g. stakeholder relationships or employee value). In some instances, there might be no clear cut difference between the two, or this would make the reporting exercise artificial. Therefore, sustainability reporting standards would appropriately integrate these disclosures alongside other sustainability disclosures, avoiding potential confusion and additional burden due to duplication of requirements.[7] In addition, as indicated in the WICI's Intangibles Reporting Framework Consultation Draft, reporting on intangible

[6] The IASB in its exposure draft on the management commentary, recognises that the undertaking's business model can be dependent on key intangible resources and that these not only encompass intangible assets recognised in the balance sheet. Some intangible resources mentioned include know-how or other intellectual capital, customer information, brands or reputation, and relationships that management identifies as key for being resources that provide the entity with a competitive advantage. Further examples can be found in Table B2 of the exposure draft.
Chapter IV of the Discussion Paper prepared by the UK Financial Reporting Council, *Business Reporting of Intangibles: Realistic proposals*, states that 'narrative reporting not only enables the provision of information on unrecognised intangibles: it can also amplify what is reported within the financial statements.'
[7] The WICI in its Intangibles Reporting Framework Consultation Draft explicitly places social and relationship capitals as part of sustainability reporting. Other frameworks, such as the IIRC give the flexibility to undertakings to categorise the capitals in different ways.

resources contributes to giving an explanation of the value creation mechanism of the organization over time, which is essential to the sustainability of the undertaking from both a socio-environmental point of view, and the perspective of the continuity or existence of the business.

Second, all information on how the undertaking's business model depends on intangible resources, and how these are a source of creation, preservation or erosion of the value of the undertaking, should be explained in the same place, in the management report. It is important to allow investors and other stakeholders assess these dependencies throughout the years, and for that purpose, the information shall be presented all together in one place. This is independent from financial disclosures in the financial statements on intangible assets, which do not cover or provide information about these dependencies of the business model.

Finally, information about this reporting area needs to be included in the sustainability reporting standards. On the one hand, comparable and relevant reporting on key intangible resources can only be ensured by specifying the details of this information in the sustainability reporting standards. On the other hand, only by treating these disclosures together with and at the same level of detail as disclosures on other sustainability matters, can we ensure that the above mentioned overlaps are avoided.

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WORKING DOCUMENT

From:	General Secretariat of the Council
To:	Working Party on Company Law (Sustainability information)
Subject:	Non-paper of the Commission services on the CSRD proposal - Intangibles

Delegations will find attached a non-paper of the Commission on the above mentioned subject.