



EUROPEAN FEDERATION OF ACCOUNTANTS AND AUDITORS FOR SMES

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# THE FINANCIAL REPORTING OF INTANGIBLES BY SMES IN EUROPE

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## INTRODUCTION

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An intangible asset is a non-monetary asset that lacks physical substance but is identifiable as a driver of value in a business entity. Another important characteristic is that intangible assets may be either purchased (externally) or generated internally within a business entity. Intangible assets are often the primary drivers of the value of a company. However, in the case of publicly accountable companies adopting IFRS, these assets are typically excluded from the balance sheet. The European Central Bank (ECB) in its [ECB Economic Bulletin, Issue 7/2018](#) observes that, although the percentage of intangible assets that are reported in company's financial statements is gradually increasing, particularly in the service sector, the underreporting of intangible assets could mean that real output is also being underreported. Moreover, the classification of intangibles as expenses to be deducted from earnings – as opposed to assets – is weighing on profits. There is a growing debate as to whether and, if so, how the value of intangibles should be disclosed in the financial reports of these companies.

Intangible assets are also often the primary drivers of value for small- and medium-sized enterprises (SMEs). But while there is significant European Union (EU) regulation governing how publicly accountable companies report intangible assets in their financial statements, the [accounting directive](#) has no explicit regulations for SME companies except for the accounting for goodwill. Therefore, the way in which SMEs report on intangibles is primarily governed by local regulation (Local GAAP).

The main issues concerning the accounting for intangible assets relate to measurement and recognition. In terms of recognition do we recognize intangible assets as capital expenditure, and so included on the balance sheet, or expense them directly to the income statement? For publicly accountable companies in Europe this is governed by IFRS. In terms of measurement of intangible assets there are important issues. Under IFRS, specifically [IAS 38 Intangible Assets](#), intangible assets (purchased or development costs) are initially measured at cost and subsequently measured at cost or using a revaluation model and amortised on a systematic basis over their useful life unless the asset has an indefinite useful life in which case it is not amortised.

The complexity of accounting for intangible assets is bound up with various perceptions which have been the subject of debates regarding the principles underpinning accounting. In particular intangible assets are seen by some as less reliable in the context of determination of value and physical existence which poses accounting problems. Another important issue is the principle that prudence should be adopted in accounting for intangibles, but the counter argument is that adopting this principle will deny users of relevant information in their decision making.

## INTANGIBLE ASSETS FROM A EUROPEAN SME PERSPECTIVE: WHY THE ACCOUNTING TREATMENT IS IMPORTANT

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From a SME perspective there are many reasons why the accounting treatment for intangibles is important, in addition to the aforementioned

reason that their inclusion reflects more accurately the true value of the company.

Harmonisation of financial reporting rules from the viewpoint of a user of financial reports is critical in making economic cross border decisions. For example, an investor in, or lender to, two companies in two separate EU member states, in judging the performance of entities needs comparable information. If one company is capitalising intangible assets and the other is expensing the expenditure, because of the varying rules in these two member states, the picture will be distorted and confusing. It would, therefore, be difficult for that investor or lender to make informed decisions about the performance of these two companies. In addition, where consolidated financial statements are required, there might be extra costs in restating the accounting numbers.

If options are available to companies whether to capitalise or expense intangible assets this also undermines comparability and may lead to companies adopting an 'earnings management' approach to financial reporting. Earnings management is a method of manipulating financial statements in order to better achieve a desired financial outcome. Companies may use earnings management to present the appearance of consistent profits by either 'smoothing' earnings' fluctuations or maximising or minimising profit. When this happens it can be hazardous for users in the decision-making process and in assessing stewardship, especially if choices can be changed and not applied consistently over time or across assets.

The International Accounting Standards Board (IASB) believes in the need for a single set of high-quality global accounting standards. The IASB argues that IFRS Standards provide a high quality, internationally recognized set of accounting standards that bring transparency, accountability and efficiency to financial markets around the world. Although, this objective of the IASB framework focuses on capital markets many argue that financial reports of SMEs in the EU would benefit from a similar objective. Users of SME financial reports would welcome information on intangible assets that is comparable across EU borders.

Conversely, there is an argument that it is important that financial reports within an EU member state should reflect the culture and the laws of that jurisdiction. This is particularly the case for financial reporting that reflects a member state's tax system.

#### IFRS AND THE TRICKLE-DOWN EFFECT

IAS 38 Intangible Assets outlines the accounting requirements for intangible assets under IFRS. The objective of IAS 38 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another IFRS. The standard requires an entity to recognise an intangible asset. In effect most purchased intangibles are treated as assets. The development costs of new products and services must also be recognised if, and only if, certain criteria are met. Other internally generated intangibles such as brands, customer relationships and research costs must be expensed as incurred. The standard also specifies how to measure the carrying amount of

intangible assets and requires certain disclosures regarding intangible assets [IAS 38.1]. It is mandatory, as mentioned above, for publicly accountable companies in Europe to follow IAS 38 when accounting for intangibles. IFRS for SMEs does not allow development costs to be recognised as an asset.

There is evidence from the EFAA survey [The Trickle Down Effect – IFRS and Accounting by SMEs](#), which examines the accounting treatment in five EU member states and shows the impact of IFRS trickling down into the local or national accounting regimes for SMEs. The five member states were Germany, the Netherlands, Portugal, Spain and the UK. It was also found that the impact was more significant in the case of medium-sized enterprises than small and micro entities. The journal *Accounting in Europe* in a Special Issue, [The Role and Current Status of IFRS in the Completion of National Accounting Rules – Evidence from Europe](#) to a great extent supports the findings of the EFAA publication.

It may be therefore that this trickle-down effect is influential in respect of IAS 38. That is, EU member states adopting IAS 38 in accounting for intangibles for their SMEs.

#### NON-FINANCIAL REPORTING DIRECTIVE (NFRD)

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The importance of accounting for intangibles has also been highlighted in the EU consultation [Public consultation on the revision of the non-financial reporting directive](#). The consultation asked whether companies should be required to disclose additional non-financial information regarding intangible assets or related factors, such as intellectual property, software, customer

retention, and human capital. In the *Summary Report of the Public Consultation on the Review of the Non-Financial Reporting Directive* it was noted that: “50% of the respondents stated that companies should be required to disclose non-financial information on intangible assets. This view is stronger among only users of non-financial information (59% of the respondents).

#### EFRAG

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In February 2020, the European Financial Reporting Advisory Group (EFRAG) published an [academic literature review on intangibles](#) and has a research project on [better information on intangibles](#).

The literature review cites some SME research. First, the 2006 EC Study “RICARDIS” devoted to research-based SMEs and their accounting problems linked to the lack of information on their intellectual capital in traditional accounting. The study concludes that the use of intellectual capital (IC) reporting as a management and reporting tool can help to counter these accounting failures and provide a better basis for decision-making to managers and investors. The study urges the EC to develop appropriate policies. Second, in 2017 the study ‘Fostering the Use of Intangibles to Strengthen SME Access to Finance,’ concludes that better accounting and reporting for intangibles by SMEs may improve their access to finance.

More recently the European Commission has asked EFRAG to undertake preparatory work for the elaboration of possible EU non-financial reporting (NFR) standards. Work has commenced in earnest – the Project Task Force for NFR standards (PTF-NFRS) is meeting

regularly at the time of writing - as the deadline for completion is early 2021.

### EFAA STUDY

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Bearing the above issues in mind and that very little is known about how private companies in EU member states account for intangibles in their financial reports, EFAA carried out a study that would give important insights into the accounting treatment of intangible assets across jurisdictions of EFAA member bodies. The study would add to the body of knowledge on, and improve the understanding of, accounting for intangibles in Europe. EFAA hoped this would be useful for policy makers, regulators, and users.

### OBJECTIVES OF STUDY

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The study had the following objectives:

- To determine the regulatory framework relating to the reporting of intangible assets by private companies in jurisdictions of the member bodies of EFAA.
- To compare the differing frameworks in the context of cross-border trade and investment.
- To establish if there are incentives, such as from the tax regime or from a government grant perspective, that influence the acquisition and valuation of intangible assets.
- To inform the current debate on intangible assets in Europe.

### JURISDICTIONS PARTICIPATING IN THE STUDY

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A short survey was sent to all 12 EFAA member organisations spanning the following 11 jurisdictions:

- Albania

- Austria
- Azerbaijan
- Belgium
- Germany
- Ireland
- Kosovo
- Portugal
- Spain
- The Netherlands
- UK

Of the 11 jurisdictions participating in the survey seven are EU member states, three are aligning their regulation to that of the EU (Azerbaijan, Albania and Kosovo), and the UK still has laws and regulations in compliance with the EU.

The next few sections summarize and discuss the survey responses.

### ACCOUNTING TREATMENT OF INTANGIBLES

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#### *General*

Table 1 summarizes the responses to the questions related to the accounting treatment for various types of intangibles. Of the eleven jurisdictions that responded to the survey only two (Albania and Kosovo) followed an international standard, that is, IFRS for SMEs, which as previously mentioned does not totally align itself with the EU accounting directive. Neither jurisdiction is currently a member of the EU. The other nine jurisdictions therefore follow their own accounting rules (Local GAAP) and as such have choices which may be influenced by local historical, legal, and cultural factors.

### *Purchased Intangibles*

It is clear there is a consensus as to how the respondents account for purchased intangibles (such as goodwill, licences, and patents) - capitalisation. The preference to adopt capitalisation of purchased intangibles may reflect what is considered as good accounting practice which in the words of the IASB are high quality understandable and enforceable accounting standards that require high quality, transparent and comparable information. This consensus to capitalise purchased intangibles may also reflect the trickle-down effect reported previously in the study by EFAA. That is, jurisdictions being influenced in their choice of adopting accounting rules based on IAS 38. Although, there was a consensus to capitalise rather than to expense there was some evidence of variation in measurement. For example, some jurisdictions allow fair value instead of cost.

### *Development Costs*

In the case of development costs of new products and services overall there was much more variation in the responses as to the accounting for these intangibles. The pattern in the variation of responses to a great extent depended on whether the entities were micro, small or medium-sized. For example, in the UK and Ireland the rules are that such development costs are expensed for micro-entities but small and medium-sized entities have the option to either expense or capitalise. This was also true for micro-entities in general where there was a preference to require the expensing of development costs. Five jurisdictions require expensing these costs. This may be because of the perceived greater risk

associated with micro-entities and the lower likelihood of products or services being developed coming to market. It could also be the result of jurisdictions trying to simplify the accounting for these micro-entities. Overall, more jurisdictions gave entities the option to capitalise or expense development costs, thereby giving entities the opportunity to adopt an earnings management approach to accounting for these costs. However, eight jurisdictions applied consistent treatment - capitalise, expense or allow entities the option to choose - across all the sizes of entities. In contrast The Netherlands, UK and Ireland made distinctions based on size.

### *Other Internally Generated*

In the case of internally generated intangibles (excluding development costs) most jurisdictions require immediate write-off of these costs (expensed). There was no variation between micro, small and medium-sized entities. Jurisdictions imposed the same accounting treatment across the range of entity sizes. Two jurisdictions took a less prudent view than international standards in the treatment of such costs by requiring their capitalisation.

Table 1: Accounting Treatment for Various Types of Intangibles by Entity Size

Jurisdiction	Type	Micro	Small	Medium-sized	Notes
Albania	Purchased intangibles	CAP	CAP	CAP	Follows IFRS for SMEs
	Development costs	EXP	EXP	EXP	
	Other Internally generated	EXP	EXP	EXP	
Austria	Purchased intangibles	CAP	CAP	CAP	
	Development costs	EXP	EXP	EXP	
	Other Internally generated	EXP	EXP	EXP	
Azerbaijan	Purchased intangibles	CAP	CAP	CAP	
	Development costs	CAP	CAP	CAP	
	Other Internally generated	CAP	CAP	CAP	
Belgium					Accelerated depreciation is available
	Purchased intangibles	CAP	CAP	CAP	
	Development costs	CAP	CAP	CAP	
Germany	Purchased intangibles	CAP	CAP	CAP	
	Development costs	OPT	OPT	OPT	
	Other internally generated	EXP	EXP	EXP	
Kosovo					Uses IFRS for SMEs
	Purchased intangibles	CAP	CAP	CAP	
	Development costs	EXP	EXP	EXP	
Netherlands	Purchased intangibles	CAP	CAP	CAP	Fair values allowed instead of cost where an active market exists
	Development costs	OPT	OPT	CAP	
	Other Internally generated	EXP	EXP	EXP	
Portugal	Purchased intangibles	CAP	CAP	CAP	
	Development costs	OPT	OPT	OPT	
	Other Internally generated	EXP	EXP	EXP	
Spain	Purchased intangibles	CAP	CAP	CAP	
	Development costs	OPT	OPT	OPT	
	Other Internally generated	EXP	EXP	EXP	
UK and Ireland					FRS102 based on IFRS for SMEs, but added option on development costs
	Purchased intangibles	CAP	CAP	CAP	
	Development costs	EXP	OPT	OPT	
Overall	Other Internally generated:				
	CAP	2	2	2	
	OPT	0	0	0	
Overall	Purchased intangibles:				
	CAP	11	11	11	
	OPT	0	0	0	
Overall	Development costs:				
	CAP	2	2	3	
	OPT	4	6	5	
Overall	EXP	5	3	3	
	Other internally generated:				
	CAP	2	2	2	
Overall	OPT	0	0	0	
	EXP	9	9	9	

Key:

Capitalise and depreciate = CAP | Expense as incurred = EXP | Option to do either = OPT



## NARRATIVE REPORTING

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In 2018 EFAA published a [Survey of Non-Financial Reporting Requirements for SMEs in Europe](#). There were 14 responses from jurisdictions within Europe. Whilst addressing a much wider subject area including environmental, social and governance (ESG) issues there was evidence that most jurisdictions required some narrative reporting supplementing the reporting of financials. Clearly, in the case of intangible assets where there may be much uncertainty and difficulty in measurement there is an expectation that narrative reporting can play a significant role in terms of discussing value, future value, amortisation and impairment. The findings from the present survey revealed that nine jurisdictions required further information beyond what appeared in the financial statements while two did not require any supporting narrative to the financial reports. Some respondents said disclosure could be made in the financial statements while others in the management report.

## CHANGES IN ACCOUNTING TREATMENT

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Respondents were asked if there had been any change in the accounting treatment of intangibles over the last 10 years. The motivation for this question was to understand whether jurisdictions during this time of intense debate on accounting for intangibles and how SMEs should account for them in their financial statements had changed their approach. Our findings indicate that seven jurisdictions had changed the way in which they account for intangibles. These changes

apparently were influenced by the treatment for intangibles in IFRS for SMEs and IFRS. This is more evidence of the trickle-down effect.

## EFFECT OF TAX INCENTIVES ON THE ACCOUNTING TREATMENT

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Respondents were asked if tax incentives influenced the way in which companies accounted for intangibles in their financial reports. In 2010 HM Revenue and Customs (HMRC), the UK's tax authority, commissioned IPSOS Mori to investigate if tax incentives given to companies to encourage investment into intangibles affected the way in which they accounted for intangibles in their financial reports. The participants were large companies. The findings, set out in the HMRC Research Report 100 '[Decision making and intangible assets](#)', indicated that taxation of intangible assets was a secondary issue for all firms participating in the study. The primary concern when acquiring or developing intangible assets is whether they support corporate strategy and improve business performance. Therefore, it seems that the taxation of intangibles may influence the accounting for intangibles but is not the primary influential factor.

Our findings for SMEs indicated that nine of the jurisdictions reported little or no influence of the tax regime on the way in which SMEs account for intangibles in their financial reports. The other two respondents reported that tax did influence the accounting for intangibles and acted as an incentive. In these jurisdictions companies with



intangibles may be incentivised to expense the costs immediately.

### THE ACCOUNTING TREATMENT AND THE DECISION TO PURCHASE OR DEVELOP INTANGIBLE ASSETS

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Respondents were asked the following question: *Some intangibles, such as computer software, may either be purchased or developed in house. Intangibles that are purchased are often capitalised and shown as an asset whereas intangibles that are developed inhouse simply expensed. Does this accounting treatment influence the decision whether to purchase or develop in-house?* The responses indicated that the decision to purchase or develop in-house intangibles assets did not influence the way a company accounted for intangibles. As one respondent put it: *“Decision drivers are mostly economic and not accounting”*. However, another respondent stated that because of the increasing importance of intangibles, their accounting treatment may affect the purchasing or investment decisions of companies, including smaller ones.

### CONCLUSIONS

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The survey demonstrated that there are significant variations between jurisdictions in Europe when it comes to the accounting treatment of intangibles.

All jurisdictions surveyed agreed on the capitalisation and amortisation of purchased intangibles.

There were, however, significant variations for the development costs of new products and services with some capitalising, some expensing immediately and others offering companies the option to do one or the other. This was also the type of intangible where distinctions were made based on the size of entities within some jurisdictions.

For other internally generated intangibles there were variations between jurisdictions with the majority expensing all such costs. However, some jurisdictions required capitalising, a less prudent approach than that of international standards.

Where there are choices to be made, two of the most obvious drivers of choice (tax and the approach of developing in-house or purchasing) did not seem to be primary influences.

Against a background of the growing importance of intangibles, for regulators and legislators there is clearly scope for improving comparability between European company accounts by increasing the harmonisation of the treatment of intangibles by SMEs. There is also room for improving the narrative reporting of these matters and the revision of the non-financial reporting directive offers an opportunity to do so.

Users of the financial statements of private companies in Europe need to be alert to the lack of comparability of information on intangibles.

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## ABOUT EFAA

The European Federation of Accountants and Auditors for SMEs (“EFAA”) represents accountants and auditors providing professional services primarily to small and medium-sized entities (“SMEs”) both within the European Union and Europe as a whole. Constituents are mainly small- and medium-sized practitioners (“SMPs”), including a significant number of sole practitioners. EFAA’s members, therefore, are SMEs themselves, and provide a range of professional services (e.g. audit, accounting, bookkeeping, tax and business advice) to SMEs.

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