30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **17 October 2006, London**

Project: **Business Combinations II**

Subject: **Assembled Workforce (Agenda Paper 2A)**

INTRODUCTION

1. At the September 2006 Board meetings, the Boards tentatively decided that intangible assets that are identifiable (ie, arising from contractual-legal rights or separable) can be measured reliably and should be recognised separately from goodwill.

2. The Business Combinations Exposure Draft (BC ED), however, proposes that an assembled workforce shall not be recognised as an intangible asset separately from goodwill. The staff has analysed the Boards' bases for that proposal and asks the following:

    a. that the Boards consider clarifying what is meant by the term 'assembled workforce' to avoid inconsistencies in application.

    b. that the Boards remove the guidance precluding the recognition of an assembled workforce separately from goodwill.

BC ED PROPOSAL AND BOARDS' BASES FOR PROPOSAL

3. Paragraph 40 of the BC ED proposes:

> For the purposes of this [draft] IFRS/Statement, an assembled workforce shall not be recognised as an intangible asset separately from goodwill.

4. The proposal is consistent with paragraph 39 of FASB Statement No. 141, *Business Combinations.* The FASB's basis for this guidance is outlined in Statement 141 as follows:

> The Board [FASB] recognizes that the intellectual capital of an assembled workforce is an important resource of many entities. The Board [FASB] therefore decided that this Statement should address whether an assembled workforce of at-will employees should be recognized as an intangible asset apart from goodwill. [Paragraph B168]
>
> Some constituents believe there are circumstances under which an assembled workforce could be viewed as meeting either the contractual-legal criterion or the separability criterion for recognition as an asset apart from goodwill. However, the Board [FASB] decided not to explicitly consider whether and in what circumstances an assembled workforce would meet those criteria. The Board [FASB] observed that even if an assembled workforce met the criteria for recognition as an intangible asset apart from goodwill, the technique often used to measure the fair value of that asset is replacement cost—the cost to hire and train a comparable assembled workforce. **The Board [FASB] believes that replacement cost is not a representationally faithful measurement of the fair value of the intellectual capital acquired in a business combination.** The Board [FASB] concluded that techniques to measure the value of an assembled workforce and the related intellectual capital with sufficient reliability are not currently available. Consequently, it decided to make an exception to the recognition criteria and require that the fair value of an assembled workforce acquired be included in the amount initially recorded as goodwill, regardless of whether it meets the recognition criteria in paragraph 39. [Paragraph B169; emphasis added]

5. IFRS 3 *Business Combinations* and IAS 38 *Intangible Assets* do not preclude the recognition of an assembled workforce, but paragraph 15 of IAS 38 states:

> An entity may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The entity may also expect that the staff will continue to make their skills available to the entity. However, **an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset**. For a similar reason, specific management or technical talent is **unlikely to meet the definition of an intangible asset**, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition. [Emphasis added.]

6. The IASB's basis for precluding the separate recognition of an assembled workforce in the BC ED is outlined in paragraph 33B of the proposed amendments to IAS 38:

> As discussed in paragraph 15, an entity **usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training to conclude that these items meet the definition of an intangible asset**. However, even in the unlikely event that an entity could demonstrate:
>
> (a) control over the future economic benefits arising from an assembled workforce acquired in a business combination; and
>
> (b) that the workforce meets one of the criteria in paragraph 12 for identifiability,
>
> it is **highly unlikely that the fair value of that workforce and the related intellectual capital could be measured with sufficient reliability**. Accordingly, [draft] IFRS 3 (revised) prohibits an acquirer from recognising an assembled workforce as an asset separately from goodwill. [Emphasis added.]

COMMENT LETTERS

7. Although the BC ED did not specifically request comments on the proposal to preclude the recognition of an assembled workforce as an intangible asset separate from goodwill, several respondents commented on the guidance. Comments were mixed. Some respondents agreed that an assembled workforce should not be recognised separately from goodwill. Other respondents suggested that the Boards reconsider the basis for the proposal. For example, [one respondent] stated:

> [Respondent] believes that the Board should reconsider its conclusion that the fair value of workforce acquired in a business combination not be recorded as an intangible asset separate from goodwill. [Respondent] notes that workforce is already valued in many cases for purposes of calculating a contributory asset charge when valuing other intangible assets. Further, due to the advances in determining fair values, [Respondent] believes that this asset is capable of being measured.

8. [Note regarding contributory asset charges: Intangible assets do not generate cash flows in a vacuum; they also rely on the use of other assets (referred to as 'contributory assets', or assets that contribute to the cash flows of the subject intangible asset). A contributory asset charge is required when using an 'excess earnings' income approach to isolate the cash flows generated by the subject intangible asset from the contribution to those cash flows made by the other assets

of the business (ie, fixed assets, working capital, other intangible assets). Contributory asset charges are hypothetical ‘rental’ charges for the use of those other assets.]

STAFF ANALYSIS

9. The remainder of this paper is structured as follows:

    a. description of the characteristics of an assembled workforce.

    b. discussion of the arguments regarding the reliability of measurement of an assembled workforce.

    c. discussion of the existence of control over an assembled workforce.

Characteristics of an assembled workforce

10. An ‘assembled workforce’ is not defined in either Statement 141 or IAS 38 and as a result there are inconsistencies in practice because preparers often have different interpretations.

11. Some hold the view (View 1) that an assembled workforce is the intellectual capital of the skilled workforce of which the acquirer has obtained the benefit as a result of the acquisition. This view implies that the assembled workforce is the (specialised) knowledge and experience that the employees bring to their jobs [Remainder of paragraph omitted from observer note].

12. Another view (View 2) is that an assembled workforce is a collection of employees that allows the acquirer to continue to operate on day one. That is to say, the acquirer does not need to go through the process of finding, hiring and training the employees because they are already in place and operating on a continuous ‘business as usual’ basis. It should be noted that ‘training’, in this context, refers to the cost that would be incurred (generally in terms of lost productivity and training course fees) to get a new employee that has experience in the job function for which he or she was hired to be sufficiently proficient in his or her new job (ie, to learn the systems and procedures for that particular company). This is not related to the knowledge and experience that are gained over time.

13. The staff agrees with the latter view that an entity's assembled workforce is simply the fact that the employees are in place and ready to perform their job functions, allowing the acquiring company to operate on day one. This is similar to the rationale that an existing customer relationship intangible asset meets the criteria to be recognised separately from goodwill; it is the fact that these relationships exist and allow the acquirer to operate functionally from day one that gives the customer relationships their value.

14. The staff also believes that, under View 1, there is a potential to double-count the intellectual capital of the employee and the 'know how' reflected in the other intangible assets of the entity (eg, proprietary technologies and processes, customer relationships, etc.).

15. The staff believes that the intellectual capital can be separated from the assembled workforce because the related intellectual capital is captured in the fair value of the entity's other intangible assets.[1] This is the case when a process or methodology can be documented and followed to the extent that the business would not be impacted materially should the employee leave the entity. In other words, the employees are relatively easy to replace without adversely affecting the fair value of the entity's other assets. This view assumes that an employee is replaceable with another person of similar background and experience. For example, a software programmer can be replaced with another software programmer. It does not assume that the programmer will be replaced with a person that has no experience with programming.

16. In most jurisdictions, the intellectual capital of an employee usually is 'owned' by the employer. Most employment contracts stipulate that the employer retains the rights to and ownership of any intellectual property created by the employee. Accordingly, it seems inappropriate to allocate those rights to the fair value of the assembled workforce. That is not to say that the intellectual capital actually resides with the employer after the employee leaves the company. Consider, for example, a chartered accountant (or certified public accountant) that moves from one accounting firm to another. The charter is retained by the employee, as is the experience and practical knowledge gained while working for the original firm.

[1] Such as the proprietary technologies and processes, in-process technology (IPR&D), and customer contracts and related relationships (including some types of maintenance and consulting contracts).

The intellectual capital (ie, the charter, experience and knowledge) of the employee means that he or she will need less training at a new job–in the same industry performing a similar job function–than would someone without those characteristics and capabilities. The fair value of the assembled workforce, in the staff's view, is not related to the knowledge that the employee has so much as it relates to the fact that he or she is able to perform at their job without having to be hired and trained–on day one.

17. In some cases, however, it would seem that the intellectual capital of the assembled workforce would be better represented if it was captured in the fair value of the workforce itself (or some portion thereof). Some would argue that this would be the case when the specialised knowledge of the employees is considered to be one of the more important contributors to the entity's value because the fair value of the other assets of the entity relies to a large extent on the ability of the workforce to develop and implement the end products or services (ie, the processes and methodologies cannot be documented because of the specialised nature of the products or services provided).

18. Consider, for example, a professional athlete (player). In such a case it would seem that the 'intellectual capital' is not separable from the employee and his or her value to the franchise would in fact comprise the majority of the value of the franchise for which he or she is employed. However, the staff would argue that the intangible asset in question is not assembled workforce, but in the contract the franchise has with the player. Player contracts for professional sports franchises, for instance, are an intangible asset that represents the vast majority of the value of a sports franchise (as high as 90 per cent of the purchase price according to valuation practitioners). Although the 'employees' clearly contribute significantly to the overall value of the business, this value is reflected in other intangible assets of the entity. In this case, it is the player contracts.

19. Continuing with the chartered accountant example, what is the fair value of the top technical partner in the firm? Under View 1, one could argue that the knowledge gained over several years of practice (the intellectual capital) is the valuable asset and should be measured and recognised as part of the assembled workforce. Under View 2, one could argue that the value is derived from the fact that the acquiring company has the benefit of having this partner employed by the

new company and able to provide services on day one. Again, the valuable asset in View 2 would not be the assembled workforce, but more than likely the partner would be covered by a non-compete contract, which could have significant value.

20. As stated previously, it is important to distinguish what is meant by the term ‘assembled workforce’ because there is the potential for double-counting when the fair value of an assembled workforce includes the related intellectual capital and that intellectual capital is already reflected in the fair value of another intangible asset. In other words, the contributory asset charge for the assembled workforce might not account adequately for the contribution of the workforce to the fair value of the other intangible assets because those assets also include the value of the intellectual capital of the employees.

21. Furthermore, the staff does not believe that the issue of double-counting is unique to assembled workforces. That is, the value of other intangible assets might be double-counted if valuation techniques are not applied properly and if the underlying premises are not understood fully. The staff does not share this concern, but clearly defining ‘assembled workforce’ should reduce the risk of double-counting. Instead of subsuming an assembled workforce into goodwill, additional guidance might be needed regarding the underlying premise for this type of intangible asset.

Reliability of measurement

22. Statement 141 was issued over five years ago. The staff agrees with the respondents who stated that it is appropriate to consider whether valuation techniques are now available to measure the fair value of an assembled workforce with sufficient reliability.

23. The staff notes that the definition of fair value has developed and been clarified in the past five years, most recently in FASB Statement No. 157, *Fair Value Measurements*. Statement 157 includes the cost approach as a valuation technique that can be used to measure fair value. It states:

> Valuation techniques consistent with the market approach, income approach, and/or cost approach shall be used to measure fair value….The cost approach is based on the amount that currently would be required to

> replace the service capacity of an asset (often referred to as **current replacement cost**)…. [Paragraph 18; emphasis added.]

24. Therefore, the staff believes that the Boards should consider whether the statement that 'replacement cost is not a representationally faithful measurement of the fair value of the intellectual capital acquired in a business combination' is still valid. If current replacement cost is identified as an appropriate valuation approach for other assets required to be measured at fair value under US GAAP, the staff cannot see a reason why replacement cost would not be a representationally faithful measure of the fair value of an assembled workforce.

25. Additionally, assembled workforces are valued for purposes of calculating a contributory asset charge when valuing other intangible assets. For this purpose, assembled workforces are often valued using a replacement cost approach (based on the costs of hiring and training/lost productivity). Indeed, if the fair value of an assembled workforce cannot be measured reliably, it follows that the fair values of all intangible assets that include a contributory asset charge for assembled workforce (ie, any using an excess earnings income approach) are likely to be stated inappropriately.

26. Furthermore, the staff believes that, based on the view that an assembled workforce is a pool of employees in place on day one, an appropriate valuation methodology would consider the cost of replacing an entity's workforce to be reflective of the fair value of the entity's assembled workforce. Clearly this would imply that the fair value of an assembled workforce measured in this way would be lower than it would be if an intellectual capital component was included.

27. However, that is not to say that it would necessarily be an insignificant asset to the acquiring entity. The fair value of an assembled workforce that is a team of specialised employees (such as the technical partner in the example above) would reflect the higher costs associated with employing highly skilled employees (in the form of higher recruiting costs, higher salaries, better benefits packages and higher training costs). This would result in a higher fair value per employee. Less skilled workers, on the other hand, would have a lower assembled workforce value (per employee) because such employees are relatively easy to find and hire, have relatively lower salaries and benefits, and have lower training costs.

Control

28. An entity has control over an asset when it ‘has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits’ (IAS 38, paragraph 13).

29. The staff points out that there is a difference between control and ownership. Although having ownership of an asset generally implies having control over the asset, it does not necessarily follow that having control over an asset can occur only through ownership. This difference applies to all assets that involve the behaviour of natural persons because people, in most areas of the world, cannot be ‘owned’. Such assets include those related to employees and customers. The staff sees no difference between an at-will employment relationship and an at-will customer relationship. It seems inconsistent, therefore, to not allow the recognition of an assembled workforce.

30. An entity receives economic benefits from its employees through their job performance, which in turn allows the entity to operate its business and to obtain profits. An entity also has power over its employees because it can require them to perform different job functions and it can replace them if their job performance is not satisfactory. An employer can restrict access of others to the benefits it enjoys from its employees by including a clause in its employment contracts that prevents the employees from doing similar work for a competing entity during the period of their employment. This gives the employer power over the employee during the employee’s employment.

31. The staff recognises that some employers do not have written employment contracts with their employees. This depends on the job function that is being performed and the jurisdiction in which they operate. The staff does not believe that the existence of a written contract is necessary. An employee and employer are bound by the agreed upon terms of employment even if they are in the form of an oral contract. The exchange of services in exchange for payment will, in many jurisdictions, qualify as a contract between the two parties. For this reason, most, if not all, employment arrangements would meet the contractual-legal criterion.

32. The staff also believes that an assembled workforce meets the separability criterion because employees are often 'leased' to other entities. This happens, for example, with employees on secondment[2] or with temporary employees.

STAFF RECOMMENDATION

33. In summary, the staff has not identified characteristics of an assembled workforce that are so unique as to prevent it from being recognised separately from goodwill, particularly given that the Boards propose to require that all other identifiable intangible assets be recognised separately.

34. The staff points out that an assembled workforce will not be recognised separately from goodwill if it does not meet the definition of an asset[3] or if it is not identifiable. That is, an intangible asset will not be recognised separately from goodwill unless it meets three criteria:

    a. identifiability (separable or contractual-legal);

    b. control over a resource; and

    c. existence of future economic benefits.

35. In addition, unlike goodwill, the useful life of an assembled workforce is not likely to be indefinite. There are two main reasons the staff does not believe that the useful life of a workforce is indefinite: (a) people do not work–or live–forever, and (b) the existing assembled workforce composition (ie, as of the acquisition date) changes over time due to employee turnover. This is similar to an existing customer relationship in which the underlying premise is that the existing customers will eventually stop doing business with the entity and they will be replaced over time with new customers.

36. The staff also believes that, if an assembled workforce meets the separate recognition criteria for an intangible asset, sufficiently reliable information will exist to measure reliably the fair value of the assembled workforce (see IASB

---

[2] A secondment is a temporarily transfer of an employee to another position, either within the same company (such as a transfer overseas) or to another company (such as a consulting firm 'leasing' its employees to a client for the duration of a project).

[3] Please note that this section is based on the current definition of an asset that is in the *Framework*. The staff believes that an assembled workforce would also fit the proposed definition: 'An asset is a present economic resource to which an entity has a present right or other privileged access'.

Agenda Paper 2B from the September 2006 meeting). That is, if an entity has obtained control over the future economic benefits arising from an assembled workforce and the assembled workforce is separable or arises from contractual-legal rights, the staff believes that sufficient information will exist to measure reliably the fair value of the assembled workforce.

37. [Paragraph omitted from observer note on the basis that it is a staff assessment of how IFRS 3 might be being interpreted.]

QUESTIONS FOR THE BOARD

38. Do the Boards think that an assembled workforce represents (1) the intellectual capital of the employees of an entity (View 1 in paragraph 10) or (2) the fact that the acquired entity has a collection of employees in place in order to operate the business on day one (View 2 in paragraph 12)?

  a. Are there other intangible assets that have meanings the Board thinks should be clarified?

39. Do the Boards agree that an assembled workforce should be recognised as an intangible asset separate from goodwill?

  a. Are there other intangible assets that the Board would like the staff to consider for recognition?