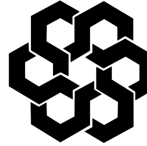

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

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

Project: **Business Combinations II**

Subject: **Preexisting Relationships and Reacquired Rights (Agenda Paper 2C)**

INTRODUCTION

1. The Business Combinations Exposure Draft (BC ED) proposes to codify the guidance in EITF Issue No. 04-1, "Accounting for Preexisting Relationships between the Parties to a Business Combination." Issue 04-1 addresses how the acquirer in a business combination should account for:

    a. The effective settlement of an executory contract or a lawsuit between the parties to the business combination (*preexisting relationship*)?

    b. The acquisition of a right that the acquirer had previously granted to the acquired entity to use the acquirer's recognized or unrecognized intangible assets (*reacquired right*)?

2. This memo:

a. Summarizes the EITF's consensus and the basis for its consensus

b. Summarizes the Boards' deliberations and basis for deciding to codify Issue 04-1 in the BC ED

c. Discusses respondents' and resource members' concerns about the accounting for preexisting relationships and reacquired rights

d. Analyzes the potential alternatives for accounting for preexisting relationships and reacquired rights and proposes some additional guidance to help eliminate some practice issues surrounding the accounting for reacquired rights

e. Asks the Boards to affirm and/or clarify the proposed accounting for preexisting relationships and reacquired rights

f. Discusses the disclosure required in Issue 04-1, which were codified in the BC ED, and proposes broadening that disclosure.

PREEXISTING RELATIONSHIPS

3. Paragraphs A91 and A92 of the BC ED propose the following guidance for accounting for preexisting relationships in a business combination:

> The acquirer and acquiree may have a relationship that existed before the business combination was contemplated. For purposes of this Statement, those relationships are called *preexisting relationships*. A preexisting relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee), or noncontractual (for example, plaintiff and defendant).
>
> In general, the effective settlement of a preexisting relationship between the acquirer and acquiree should be accounted for in the same way whether it is settled as part of a business combination or separately from a business combination. Therefore, if the business combination results in the effective settlement of a preexisting relationship, the acquirer recognizes a gain or loss and measures it as follows:
>
> a. A noncontractual preexisting relationship (such as a lawsuit) should be measured at fair value.
>
> b. A contractual preexisting relationship should be measured as the lesser of the following:
>
>   (1) The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items.

(2) Any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable.

To the extent that (2) is less than (1), the difference should be included as part of the business combination accounting. Also, an unfavorable contract is not necessarily a loss contract for the acquirer.

4. That guidance is based on the guidance in Issue 04-1. It was paraphrased for consistency with the BC ED but is intended to be the same. The purpose of the guidance is primarily to prevent an entity from avoiding income statement recognition for the effective settlement of an onerous contract or pending unfavorable litigation by acquiring the counterparty to the contract or the plaintiff.

5. In July 2006, the Boards agreed with the following general principles and related guidance:

> The acquirer should assess whether a business combination includes any transactions that are substantively separate from the acquisition of assets and assumption of liabilities that make up the acquiree. Only the consideration transferred and the assets acquired or liabilities assumed that make up the acquiree should be accounted for using the acquisition method. Other transactions should be accounted for separately in accordance with other IFRS/U.S. GAAP.
>
> A transaction is substantively separate from a business combination if it was arranged by or on behalf of the acquirer and/or initiated primarily for the economic benefit of the acquirer or the combined entity (rather than for the benefit of the acquiree or its former owners prior to the business combination).
>
> The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, to determine whether a transaction or event is initiated primarily for the economic benefit of the acquirer or combined entity, rather than for the acquiree or its former owners prior to the business combination:
>
> a. The reasons for the transaction or event
> b. Who initiated the transaction or event
> c. The timing of the transaction or event. [Minutes of the July 19, 2006 FASB Board meeting]

6. The staff believes that the guidance in A91 and A92 of the BC ED for recognizing preexisting relationships is consistent with the principles for

determining whether a business combination includes any transactions that are substantively separate from the acquisition of assets and assumption of liabilities that make up the acquiree. It, however, goes a step further than the principle by describing how to measure the effective settlement gain or loss since that measurement may not be intuitive from the principle alone.

7. The EITF considered whether the settlement of a *contractual* preexisting relationship should be measured the same way as a *noncontractual* preexisting relationship, that is, at fair value. However, the Task Force believed that a fair value measurement is not appropriate if the contract provides specific settlement terms or the contract was cancelable by the acquirer without penalty.

Example

8. The following example illustrates how the settlement gain or loss on a contractual preexisting relationship is calculated:

> Company X purchases electronic components from Company Y under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than rates at which Company X could purchase similar electronic components from another supplier. The supply contract includes provisions that Company X can only terminate the contract before the end of the initial 5-year term by paying a $6 million penalty. With 3 years remaining under the supply contract, Company X pays $50 million (net of liabilities assumed) to acquire Company Y (fair value of Company Y based on what marketplace participants would be willing to pay).
>
> Assume that included in the total fair value of Company Y is $8 million related to the fair value of the supply contract with Company X. Further, assume that the $8 million can be further bifurcated into a $3 million "at-market" component (selling effort, customer relationships, and so forth) and a $5 million "off-market" component (pricing is favorable to Company Y). Also assume, for simplicity, that Company Y has no other identifiable assets or liabilities related to the supply contract and that Company X has not recognized any assets or liabilities related to the supply contract before the business combination.

9. Based on the guidance in the BC ED and Issue 04-1, the settlement amount should not exceed any stated settlement provisions. Therefore, the settlement amount would be measured at the lesser of (a) the amount by which the contract is favorable or unfavorable or (b) any stated settlement provisions. In the above example, because the stated settlement amount is greater than the amount by which the contract is favorable to the acquired entity, the settlement amount would be measured as a $5 million loss that Company X would recognize as an expense on the acquisition date. However, if the stated settlement amount was less than $5 million, the settlement would be measured at that lesser amount. That is because it is assumed that the acquirer (or any marketplace participant) would not pay in excess of any stated settlement provisions to cancel the contract.

10. Some would argue that, in concept, Company X has an $8 million liability and Company Y has an $8 million asset before the acquisition. However, existing GAAP and IFRSs generally preclude recognition of those assets and liabilities (or portions thereof). If those amounts were properly recognized in Company X's and Company Y's financial statements, then they would eliminate when Company X acquires Company Y and no gain or loss would be recognized. But because existing GAAP and IFRSs (often) preclude recognition of such assets or liabilities, the accounting in Issue 04-1 is a means of correcting such nonrecognition upon the acquisition date.

Comment Letter Responses/Practice Issues

11. The staff notes that few of the comment letters addressed the proposed accounting for preexisting relationships. (Most of the comment letters that did address the codification of Issue 04-1 focused on reacquired rights. That issue is discussed below.) Those comment letters that did address preexisting relationships generally disagreed that an acquirer should recognize a settlement gain or loss for the effective settlement of a preexisting relationship. They believed that the preexisting relationship is

inextricably linked to the business combination and, therefore, should not be separately recognized. For example, one respondent stated:

> .. . . we do not agree with recognizing a gain or loss on the effective settlement of pre-existing relationships. In our experience, the transactions are inextricably linked and the settlement would not occur without the successful completion of the business combination transaction. [Pepsi Co.; CL #282]

12. The staff contacted resource group members and the SEC staff to determine if there are issues in practice in applying the consensus in Issue 04-1 for preexisting relationships. Resource group members stated that they generally do not encounter issues in applying the consensus to preexisting relationships. They stated that they do sometimes encounter valuation issues, but they agreed that the business combinations standard would not be the place to include valuation guidance. (And they also agreed that the guidance in Statement 157 will be helpful in valuing those relationships, at least for FASB constituents).

Clarification—"Loss Contract"

13. Issue 04-1 and the BC ED stated that "an unfavorable contract is not necessarily a loss contract for the acquirer." A few respondents asked for clarification about what that sentence means. The staff believes that the EITF only intended to highlight that an *unfavorable contract* is different from a *loss (onerous) contract*. An unfavorable contract is a contract in which the terms are unfavorable compared to the pricing an entity could get if it entered into the contract in the market today. However, that does not mean that the contract is onerous. The economic benefits that an entity expects to receive from an unfavorable contract could still outweigh the costs the entity expects to incur. On the other hand, a loss (onerous) contract is one in which the economic benefits that the entity expects to achieve are less than the costs the entity expects to incur. In that case, the entity *might* have a liability recorded for the loss contract (if permitted to accrue a liability for the loss

contract under U.S. GAAP or IFRS). Unless Board members object, the staff plans to clarify this point in drafting.

Staff Recommendation

14. The staff recommends retaining the proposed guidance that would require that the effective settlement of a preexisting relationship be accounted for separately from the business combination. That guidance is consistent with the principles for assessing whether a business combination includes any transactions that are substantively separate from the acquisition. The staff also believes that the guidance for measuring the effective settlement of a preexisting relationship is consistent with that principle but that it is necessary because the measurement may not be intuitive without the additional guidance. Therefore, the staff recommends that the Boards affirm the proposed guidance for accounting for preexisting relationships.

Do the Boards want to affirm the proposed guidance for accounting for preexisting relationships?

REACQUIRED RIGHTS

15. Paragraph 41 of the BC ED provides the following guidance:

> As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use the acquirer's recognized or unrecognized intangible assets (such as a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement). Such a right is an identifiable intangible asset that shall be recognized separately from goodwill as part of the business combination accounting. If the contract giving rise to the reacquired right includes pricing terms that are favorable or unfavorable when compared with pricing for current market transactions for the same or similar items, the acquirer shall recognize a settlement gain or loss. Paragraph A92 provides guidance for measuring that settlement gain or loss. After initial recognition, reacquired rights shall be amortized over the remaining contractual period of the precombination contract that granted those rights.

16. That guidance is based on the guidance provided in Issue 04-1. In that Issue, the EITF concluded that:

> The Task Force reached a consensus on Issue 3 that *the acquisition of a right that the acquirer had previously granted to the acquired entity to use the acquirer's recognized or unrecognized intangible assets (for example, rights to the acquirer's trade name under a franchise agreement or rights to the acquirer's technology under a technology licensing agreement, hereinafter referred to as a "reacquired right") should be included as part of the business combination.* The Task Force observed that if the contract giving rise to the reacquired right includes terms that are favorable or unfavorable when compared to pricing (for example, royalty rates) for current market transactions for the same or similar items, an entity should measure a settlement gain or loss as the lesser of (a) the amount by which the contract is favorable or unfavorable to market terms from the perspective of the acquirer or (b) the stated settlement provisions of the contract available to the counterparty to which the contract is unfavorable. Refer to the consensus in Issue 2 for additional guidance on the measurement of the settlement amount for the favorable or unfavorable terms or the settlement provisions of the contract.

> *The Task Force reached a consensus on Issue 4 that a reacquired right (which would exclude the amount recognized as a settlement gain or loss as a result of the application of the consensus in Issue 3) should be recognized as an intangible asset apart from goodwill.* The Task Force observed that Statement 142 requires that the fair value of all identifiable intangibles, including trade name and technology assets, be separately valued when determining implied goodwill. For example, if an entity reacquires the right to its trade name in a certain geographic location, the entity should recognize the value of the reacquired trade name as either a separate intangible asset or a part of its recognized trade name. The entity is not required to allocate the cash flows associated with its trade name to separate assets that represent other geographic locations in Step 2 of the goodwill impairment test. [Paragraphs 5 and 6; emphasis added.]

17. The IASB and FASB discussed the accounting for reacquired rights at their December 2004 and February 2005 Board Meetings. The materials and minutes for that meeting can be accessed from the FASB's Intranet or will be made available in hard copy upon request.

18. At those meetings, the Boards agreed with the EITF's conclusion relating to reacquired rights and settlement gains or losses for any off-market component of the reacquired right. In addition, the Boards decided to provide some guidance for the subsequent accounting for reacquired rights. A few IASB members had expressed concern about determining the useful life of a reacquired right, which Issue 04-1 did not address. Because the acquirer would control the right after the acquisition, the acquirer could assume an infinite number of renewals. That could result in the right being classified as indefinite-lived (not amortized). Therefore, the Boards decided that, subsequently, those rights should be amortized over the remaining contractual period of the precombination contract that granted those rights up until the first right of renewal. That is to say, the amortization period must be based on the contract terms and not include non-contractual renewals.

Comment Letter Responses/Practice Issues

19. The Boards did not specifically solicit input on reacquired rights in the Notice/Invitation; however, a few respondents did raise this issue in their comment letters. Those who responded generally disagreed that an acquirer should recognize a reacquired right as a separately identifiable intangible asset because separate recognition would lead to the acquirer recognizing an internally-generated intangible asset as part of the business combination. A few respondents believed that a reacquired right should be recognized as part of goodwill, whereas one respondent believed that a reacquired right should be recognized as a settlement of a preexisting relationship.

20. The staff also contacted some resource group members and the SEC staff to determine whether there are practice issues with reacquired rights. They identified two issues that the staff believes warrant further consideration:

    a. Determining the useful life of a reacquired right and whether the useful life should impact its initial measurement

    b. Accounting for the reissuance of a reacquired right.

21. The staff discusses those issues later in this memo.

Staff Analysis

Initial Recognition of a Reacquired Right

22. The staff considered three alternatives for the initial recognition of reacquired rights in a business combination:

    a. **Alternative One**: Recognize a reacquired right as a *settlement of a preexisting relationship* (an *expense*).

    b. **Alternative Two**: Recognize a reacquired right as part of *goodwill*.

c. **Alternative Three**: Recognize a reacquired right as a *separately identified intangible asset*.

Example Illustrating the Three Alternatives

23. Consider the following example for accounting for reacquired rights in a business combination:

> Acquirer Co. grants a franchise right to Target Co. to operate under Acquirer Co.'s name in the Northeast region. Two years later, Acquirer Co. decides to expand its business and enters into an agreement to acquire Target Co for $50,000. Target Co.'s business consists of the franchise right (fair value $20,000), a customer list (fair value $10,000), some operating assets and liabilities (net fair value $15,000), an assembled workforce (recognized as part of goodwill), and processes. At the time of the acquisition, the franchise right is at *market terms* (therefore, Acquirer Co. would not recognize an off-market settlement gain or loss). Under each of the alternatives, Acquirer Co. would recognize the acquisition and the franchise right as follows:

	Alternative One	**Alternative Two**	**Alternative Three**
Dr. Tangible net assets	15,000	15,000	15,000
Dr. Intangible assets	10,000	10,000	30,000
Dr. Goodwill	5,000	25,000	5,000
Dr. Expense	20,000	-	-
Cr. Cash	(50,000)	(50,000)	(50,000)

Analysis of Alternatives

Alternative One

24. Under Alternative One, the reacquired franchise right is recognized as an *effective settlement of a preexisting relationship* (an *expense*). Supporters of Alternative One believe that all preexisting relationships in a business combination should be accounted for the same way. A reacquired right is a type of preexisting relationship. Therefore, the acquirer is effectively settling the relationship by reacquiring that right. However, opponents of Alternative One believe that reacquired rights are different from lawsuits or other

executory contracts that are effectively settled as part of a business combination. Therefore, they should be accounted for differently.

25. Opponents of Alternative One believe that, in the example described above, Acquirer Co. is not effectively settling the contract. The right to operate in the Northeast region still exists and Acquirer Co. will continue to receive the benefits of that right in the form of cash flows; the only difference is that after the acquisition, Acquirer Co., rather than Target Co., controls the right. Therefore, Acquirer Co. has not incurred a loss. Opponents of Alternative One also note that if any other marketplace participant was to acquire that right, it would be recognized as an asset, not as a loss. Therefore, it seems inappropriate for Acquirer Co. to recognize an expense for the reacquired right.

26. Supporters of Alternative One believe that the net result of this alternative is as if the accounting had been done correctly from Day 1. That is, under current practice, when an entity issues a franchise right, the following entries are recorded:

Franchisor			**Franchisee**	
Dr. Asset (receivable)	100		Dr. asset (franchise right)	100
Cr. Income	(100)		Cr. Cash	(100)

However, conceptually, the franchisor has a performance obligation at the date the franchise is granted. So, instead, the franchisor should recognize a liability instead of income, as follows:

Franchisor			**Franchisee**	
Dr. Asset (receivable)	100		Dr. asset (franchise right)	100
Cr. Liability	(100)		Cr. Cash	(100)

27. Therefore, supporters of Alternative One believe that the franchisor initially should recognize a liability when it first issues the franchise. If that happened, then the franchisor's liability and the franchisee's asset would eliminate in the business combination. However, because the franchisor recognized income

instead of a liability initially, applying Alternative One would result in expensing the asset which would eliminate against the previously recognized income (albeit likely in different reporting periods).

Alternative Two

28. Under Alternative Two, the reacquired franchise right is recognized as part of *goodwill*. Supporters of Alternative Two believe that, from the perspective of Acquirer Co., the reacquired right is not the same as other acquired intangible assets. In the above example, there is no longer a franchising relationship between Acquirer Co. (parent) and Target Co. (subsidiary). Therefore, the reacquired right can not be accounted for as a franchising rights intangible asset because any franchising relationships no longer exist from the perspective of the combined entity. The initial accounting should not look to what was an asset of the acquiree before the business combination. Effectively, the acquirer reacquired its ability to enter into a franchising agreement in the Northeast region with another third party. The ability to enter into a franchising agreement with another party is not recognized as intangible assets under existing GAAP and IFRSs; they are in the nature of goodwill. Therefore, those types of assets should be subsumed in goodwill in a business combination.

29. Supporters of Alternative Two agree that from the perspective of any other marketplace participant, the intangible right would meet the criteria for recognition as a separate intangible asset. However, from the perspective of the acquirer, the reacquired right is in the nature of goodwill or other internally-generated intangible assets that are not recognized as intangible assets.

30. Opponents of Alternative Two have three concerns. The first is that this alternative could not be applied to an asset acquisition. That is, if Target Co. did not meet the definition of a business, Alternative Two would not work because an entity cannot recognize goodwill in a transaction that does not

qualify as a business combination.[1] The staff notes that given the broad definition of a business combination, it may be unlikely that such a transaction in which a right and some other assets are acquired could qualify as an asset acquisition. However, it remains a possibility. The second concern is that by subsuming the value of the reacquired right into goodwill, Acquirer Co. is providing less decision-useful information to users of its financial statements than if the reacquired right was separately recognized. The third concern is that by subsuming the reacquired right into goodwill, the reacquired right could remain in goodwill indefinitely rather than be amortized over its useful life.

Alternative Three

31. Under Alternative Three, the reacquired franchise right is recognized as a *separately identified intangible asset*. Supporters of Alternative Three believe that separate recognition is consistent with an objective of Statement 141 and IFRS 3, which was to separately recognize as many identifiable intangible assets as possible because that provides the most decision-useful information to users of financial statements. They also believe that another benefit is that the reacquired right would be amortized rather subsumed into goodwill where it could remain indefinitely.

32. Supporters also note that Alternative Three is most consistent with the market participant view; that is, the accounting would be the same whether Acquirer Co. reacquires its own right or whether an unrelated, third-party acquires the right. This alternative also avoids the problems associated with Alternatives One and Two. That is, the seemingly inappropriate recognition of an expense when no value has been lost, less decision-useful information provided by subsuming the right into goodwill and not amortizing it, unclear accounting if the transaction does not qualify as a business combination.

[1] Some staff members believe that this argument is backwards. They believe that it just illustrates that the accounting for asset acquisitions is inappropriate and that an entity should be allowed to recognized goodwill on bundled asset acquisitions.

33. Supporters of Alternative Three also assert that the required right should be recognized separately even though the underlying asset—in our example, the franchise—may be unrecognized in the consolidated financial statements. The fact that the reacquired right was part of an exchange transaction distinguishes that asset from other internally-generated intangible assets that remain unrecognized in the consolidated financial statements.

34. Alternative Three also is most consistent with the recognition principle the Boards agreed to in March 2006:

    > In a business combination, the acquirer recognizes all of the assets acquired and all of the liabilities assumed.

35. Supporters of Alternative Three also note that this alternative eliminates potential goodwill impairment issues under U.S. GAAP. In Step 2 of the U.S. goodwill impairment test, Statement 142 requires an entity to allocate the fair value of a reporting unit to the individual assets and liabilities to determine the implied fair value of the goodwill. An entity should allocate the fair value *as if the reporting unit had been acquired in a business combination*. Consider the following example:

    > A franchisor acquires an operating franchisee's business in a business combination and does not allocate any purchase price to reacquired franchise rights (that is, it is subsumed in goodwill). The entity performs its annual goodwill impairment test and the fair value of a reporting unit is below its carrying amount.

36. In this example, the franchisor is required to allocate the reporting unit's fair value to its assets and liabilities. Any value attributable to reacquired franchise rights (and other similar internally-generated intangible assets) is required to be considered an intangible asset apart from goodwill under Statement 142. That is, if the intangible asset was subsumed in goodwill, more fair value would be allocated to intangible assets, which would result in less residual value attributed to goodwill. As a result, the franchisor may be required to recognize a goodwill impairment charge (or a larger goodwill impairment charge.)

37. Opponents of Alternative Three assert that the asset that would be recognized is only a proxy for the underlying asset to which the rights relate. For example, a franchise right will normally give the holder the right to use a brand and, possibly, access to a supply chain managed by the franchisor. It is the brand and the supply chain that have the underlying value. By reacquiring the right in a business combination the acquirer regains its exclusive rights over those assets rather than just the right to use them granted by the franchise. Arguably, therefore, it is those underlying assets that should be recognized when they are reacquired in a business combination.

Staff Recommendation

38. The staff reluctantly recommends Alternative Three. While some staff members are uncomfortable with this alternative because it seems to allow an acquirer to recognize an internally-generated intangible asset, the staff believes that, on-balance, Alternative Three is the best solution. The staff who are uncomfortable with Alternative Three acknowledge that their uneasiness only arises because of the existing mixed-model for recognizing intangible assets. If entities recognized internally-generated intangible assets in the financial statements, then Alternative Three would seem more logical.

Do the Boards agree that the acquirer should account for a reacquired right in a business combination as a separately identifiable intangible asset?

Determining the Useful Life of a Reacquired Right and Whether the Useful Life Should Impact its Initial Measurement

39. Some Board members and constituents expressed concerns about the useful life of a reacquired right under Alternative Three. Since the acquirer effectively controls the reacquired after the acquisition because it controls the assets of the acquiree, the acquirer could assume an infinite number of renewals. That could result in the right being considered indefinite-lived (not

amortized). Additionally, if an entity was to assume that a reacquired right had an indefinite life, then it would likely be *measured* assuming an infinite number of renewals. As a result, it could be initially measured at a very significant amount and not amortized.

40. The Boards addressed the first issue in the BC ED by providing some guidance for determining the useful life of a reacquired right. Paragraph 41 of the BC ED stated: "….after initial recognition, reacquired rights shall be amortized over the remaining contractual period of the precombination contract that granted those rights." However, the BC ED does not address measurement. Therefore, an entity might still assume noncontractual renewals in the *measurement* of the reacquired right.

41. If the Board affirms Alternative Three (separate recognition of reacquired rights), the staff believes the Boards should provide subsequent accounting guidance in the final business combinations standard. That is, the staff believes the Boards should:

    a. Provide guidance for determining the useful life of a reacquired right

    b. Provide guidance for measuring a reacquired right.

Useful Life

42. The staff understands the concern that some Board members expressed during initial deliberations. That concern was that some acquirers would assume an infinite number of renewals and classify a reacquired right as indefinite-lived. In fact, based on conversations with resource group members, such classification had been occurring in practice. However, the SEC recently limited that practice. In a December 5, 2005 speech given by Brian K. Roberson, SEC Professional Accounting Fellow, he directed constituents to the guidance in the BC ED for determining the useful life of a reacquired right.

43. However, the staff notes that if the Boards decide to limit the useful life of a reacquired right to the remaining contractual life, that decision would presumably impact its measurement (discussed next) and may not equate to the manner in which the reacquisition price was determined between the parties or to the price that another marketplace participant would have to pay to acquire that right. Thus, any difference between the value of the reacquired right to the acquirer and the value of the right to any other marketplace participant (which might be larger if renewals are assumed in the measurement) could be subsumed in goodwill.

Measurement of the Reacquired Right

44. The staff notes that the guidance in the BC ED does not address measurement. It is not clear whether the Boards also intended to limit the *measurement* of the reacquired right to the contractual terms of the agreement. There are two alternatives:

   a. **Alternative One**: Limit the measurement of the reacquired right to the terms of the existing contract.

   b. **Alternative Two**: Allow noncontractual renewals to be factored into the measurement of the reacquired right.

Alternative One

45. The argument in favor of Alternative One is consistency with the determination of the useful life. That is, if the Boards decide to limit the useful life of a reacquired right to the remaining contractual terms, then its measurement should be limited to the remaining contractual terms. Otherwise, the acquirer could assume an infinite number of renewals in measuring the fair value of the intangible asset, but then amortize that asset over a significantly shorter period (contractual life). However, a consequence of this alternative is that any difference between the acquirer's measurement and the measurement by another marketplace participant would be subsumed in goodwill.

Alternative Two

46. The argument is favor of Alternative Two is consistency with the marketplace participant perspective. That is, if any other marketplace participant would include the noncontractual renewals in measuring the reacquired right, the acquirer should as well. However, a consequence of this alternative is that if the Boards decide to limit the useful life of the reacquired right to the remaining contract term, then the reacquired right could potentially be valued at a very large amount and then be amortized over a very short period which would not mirror its useful life.

Staff Recommendation

47. The staff recommends limiting the useful life of a reacquired right to its remaining contractual life. The staff acknowledges that this recommendation is inconsistent with a marketplace participant perspective. However, it mitigates the seemingly wrong interpretation that those reacquired rights could be indefinite-lived.

48. The staff is divided on our recommendation about how to measure a reacquired right.

Do the Boards want to include guidance in the final business combination standard that limits the useful life of a reacquired right to the remaining contractual life of the contract between the two parties?

Do the Boards want to limit the measurement of the reacquired right to the remaining contractual life so that an acquirer cannot assume any noncontractual renewals in the measure of the right?

Accounting for the Reissuance of a Reacquired Right

49. Another practice issue that was raised by two resource group members is how to account for the reissuance of a reacquired right. That is, if an entity reacquires a right in a business combination, recognizes it as a separately

identified intangible asset, and then reissues that right to an unrelated, third party, how would the entity account for the reissuance?

50. The staff notes that this issue is not a business combination issue. It is a Day 2 issue that some could argue should not be addressed in the business combinations project. However, others would argue that the Boards have a responsibility to try to eliminate known practice problems (or potential requests for additional guidance) whenever practicable. Since this will continue to be a problem if the Boards codify the guidance for reacquired rights, the final business combinations standard should address it.

51. If the Boards decide to address this issue, the staff identified two alternatives:

  a. **Alternative One**: Charge any remaining unamortized asset against the proceeds received from the reissued right

  b. **Alternative Two**: The value of the reacquired right would not change upon reissuance and it would continue to be amortized over the previously determined useful life.

Analysis of Alternatives

Example Illustrating the Two Alternatives

52. Consider the following example for accounting for the reissuance of a reacquired right:

> Acquirer Co. grants a franchise right to Target Co. to operate under Acquirer Co.'s name in the Northeast region. Two years later, Acquirer Co. acquires Target Co for $50,000. The reacquired franchise right is recognized at $20,000 and it has a 4 year useful life. One year later, Acquirer Co. reissues the right to Company X for $60,000 for a 5 year term. At that time, the carrying value of the right is $15,000. Under each of the alternatives, Acquirer Co. would recognize the reissuance as follows:

	Alternative One	**Alternative Two**
Dr. Cash	60,000	60,000
Cr. Income	(35,000)	(60,000)
Cr. Intangible asset	(15,000)	-

Alternative One

53. Under Alternative One, the remaining unamortized balance of the reacquired right would become part of the income or loss recognized upon reissuing the right. Supporters of this alternative believe that if the right is sold to another party, it is inappropriate to keep the right on the acquirer's books. Therefore, it is appropriate to eliminate the asset in calculating the gain or loss.

54. The staff notes that this alternative could result in a loss if the right was valued upon reacquisition at an amount in excess of the amount the entity charges for the sale of a new right. However, that issue should be mitigated if the Boards decide to limit the useful life and the measurement of the right to the life of the contract.

Alternative Two

55. Under Alternative Two, the value of the reacquired right would not change upon reissuance and it would continue to be amortized over the previously determined useful life. Supporters of this view argue that the reissuance of the right would be expected to increase the overall fair value of the entity and, thus, they do not believe that expensing the reacquisition price is appropriate since the amount is not impaired.

Staff Recommendation

56. The staff recommends Alternative One.

Do the Boards want to include guidance in the final business combination standard for reissuing a reacquired right?

If so, how should an entity account for the reissuance?

Settlement Gain or Loss on a Reacquired Right

57. Issue 04-1 requires and the BC ED proposes that any off-market component of a reacquired right should be recognized as a settlement gain or loss. Paragraph 41 of the BC ED states that "if the contract giving rise to the reacquired right includes pricing terms that are favorable or unfavorable when compared with pricing for current market transactions for the same or similar items, the acquirer shall recognize a settlement gain or loss." The BC ED then refers to the guidance for preexisting relationships for determining how to calculate the settlement gain or loss.

Staff Recommendation

58. The staff believes that recognizing the off-market component of a reacquired right as a gain or loss separate from the business combination accounting is consistent with the Boards' decision about assessing whether a business combination includes any transactions that are substantively separate from the acquisition of assets and assumption of liabilities that make up the acquiree. In addition, it would preclude an entity from avoiding income statement recognition for effectively settling an onerous (below market) contract by acquiring the counterparty to the contract. Therefore, the staff recommends retaining that requirement.

Do the Boards agree that the acquirer should recognize a settlement gain or loss if the contract giving rise to the reacquired right includes terms that are favorable or unfavorable when compared to pricing for current market transactions for the same or similar items?

DISCLOSURES

59. Paragraph 72(k) of the BC ED, which was codified from Issue 04-1, proposes the following disclosure when the acquirer and acquiree have a preexisting relationship in a business combination:

> In a business combination in which the acquirer and acquiree have a preexisting relationship:
> (1) The nature of the preexisting relationship
> (2) The measurement of the settlement amount of the preexisting relationship, if any, and the valuation method used to determine the settlement amount
> (3) The amount of any settlement gain or loss recognized and the line item in the income statement in which that gain or loss is recognized.

60. The staff believes that this disclosure should be broadened to address any transactions that occur simultaneously with the business combination, but are "substantively separate" from the acquisition and are, therefore, accounted for separately in accordance with other IFRSs/U.S. GAAP. Thus, the staff proposes linking a disclosure by paragraph reference to the guidance for determining what is part of the business combination. If a transaction occurs simultaneously with the business combination but is determined to be a separate transaction based on the criteria for determining what is part of the combination, then the acquirer should be required to disclose the details of that transaction. The staff proposes the following:

> The acquirer shall disclose . . .
>
> … . . If the business combination includes any transactions that are substantively separate from the acquisition of assets and assumption of liabilities that make up the acquiree (see paragraph X)~~ In a business combination in which the acquirer and acquiree have a preexisting relationship~~:
> (1) The nature of ~~the~~ each separate transaction~~preexisting relationship~~
> (2) How the acquirer accounted for the separate transaction
> (3) The amount of the separate transaction and the line item in the financial statements where the transaction is recognized

(~~3~~<u>4</u>) ~~The measurement of the settlement amount of the preexisting relationship, if any, and~~<u>If the separate transaction is the effective settlement of a preexisting relationship,</u> the valuation method used to determine the settlement amount

~~(3) The amount of any settlement gain or loss recognized and the line item in the income statement in which that gain or loss is recognized.~~

61. The staff believes that the acquirer should be required to disclose the nature and amount of each separate transaction (such as transaction costs, settlements of preexisting relationships, compensation arrangements and so on). The staff also believes that by broadening the disclosure, that some of the disclosures that were proposed in the BC ED can be consolidated.

Do the Boards want to broaden the disclosure to address all separate transactions?

Do the Boards have any suggestions for improving the disclosure proposed by the staff?