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**International
Accounting Standards
Board**

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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: 22 September 2006, London

Project: BUSINESS COMBINATIONS—PHASE II

Subject: Intangible Assets (Agenda Paper 2B)

INTRODUCTION

1. The Business Combinations Exposure Draft (BC ED) proposes that identifiable intangible assets acquired in a business combination be recognised at their acquisition-date fair values. This proposal would resolve a difference between IFRS 3 *Business Combinations* and FASB Statement No. 141, *Business Combinations*, relating to the criteria for recognising an intangible asset separately from goodwill. In the deliberations that led to IFRS 3 and Statement 141, both Boards concluded that an intangible asset must be identifiable (arising from contractual-legal rights or separable) to be recognised separately from goodwill. The FASB also concluded that the notion of identifiability serves as a reliability threshold for the recognition of intangible assets separately from goodwill because the FASB concluded that, when acquired in a business combination, all intangible assets (except for an assembled workforce) that are identifiable can be measured with sufficient reliability to warrant recognition separately from goodwill.
2. In addition to the identifiability criterion, IFRS 3 and IAS 38 *Intangible Assets* also include a separate statement that an intangible asset must be able to be

measured reliably to be recognised separately from goodwill. Therefore the IASB and FASB are using the notion of *identifiability* (arising from contractual-legal rights or separable) differently in their existing guidance. IFRS 3 incorporates *identifiability* into the definition of an intangible asset and Statement 141 uses *identifiability* as a reliability threshold for the recognition of intangible assets separately from goodwill.

3. In the BC ED, the IASB decided to converge with the FASB by:
 - a. eliminating the statement that an intangible asset must be able to be measured reliably to be recognised separately from goodwill; and
 - b. precluding the recognition of an assembled workforce acquired in a business combination as an intangible asset separately from goodwill.
4. The BC ED proposes that identifiable intangible assets should be measured at their acquisition-date fair values. The BC ED uses the definition of *fair value* in the FASB's *Fair Value Measurements* (FVM) ED—'the price at which an asset or liability could be *exchanged* in a current transaction between knowledgeable, unrelated willing parties'. In its redeliberations of the FVM standard, the FASB clarified an exit price objective for fair value measurements and revised the definition of *fair value* to be 'the price that would be *received to sell* an asset or *paid to transfer* a liability in an orderly transaction between market participants at the measurement date'.
5. IFRS 3 and Statement 141 already require identifiable intangible assets to be measured at fair value. The staff plans to develop a paper that addresses the differences between entry value and exit value in the context of business combinations and what measurement attribute should be used in the final business combinations standard.¹ Because the discussion on those issues has not yet taken place, the staff uses the terms *market value* and *fair value* interchangeably in this paper. For purposes of this discussion, the staff assumes that the entry value and

¹ At its September 2006 meeting, the IASB will consider whether its FVM Discussion Paper should discuss two views—one supporting the exit price measurement objective and the other separating fair value into an entry price measurement objective when an asset or liability is measured at fair value at initial recognition and an exit price measurement objective for subsequent fair value measurements—rather than stating a preference for the exit price measurement objective. In the agenda paper for that meeting, the IASB staff proposes to define an *entry price* as 'the price that would be *paid to acquire* an asset or *received to assume* a liability in an orderly transaction between market participants at the measurement date'.

the exit value of intangible assets acquired in a business combination will be the same.

6. In light of recent discussions in the FASB's project on a proposed FASB Staff Position (FSP) on the measurement of non-financial assets, this paper addresses whether a market value or an entity-specific value should be used for intangible assets acquired in a business combination.²
7. This paper is structured as follows:
 - a. Section 1—Background information and comment letter summary
 - i. Comparison of BC ED proposal with existing guidance
 - ii. Previous Board deliberations in Phase II of the BC project
 - iii. Summary of comment letter responses
 - b. Section 2—Staff analysis
 - i. Issue A—Should intangible assets be recognised separately from goodwill?
 - ii. Issue B—Should a market value or an entity-specific value be used to measure intangible assets?
 - iii. Issue C—Can the market value of identifiable intangible assets be measured reliably?
 1. Sub-Issue C1—Meaning of *sufficient reliability*
 2. Sub-Issue C2—Can all identifiable intangible assets be measured reliably?
 3. Sub-Issue C3—Alternatives if Boards decide that some identifiable intangible assets might not be able to be measured reliably at market value
 - iv. Issue D—Do the benefits of recognising identifiable intangible assets at fair value outweigh the costs?
 - c. Appendix A—Summary of the FASB's FSP project on the measurement of non-financial assets
 - d. Appendix B—Explanation of how identifiable intangible assets are measured in practice

² At its 28 June 2006 meeting, the FASB decided to add a project to its agenda to address the diversity in practice that has arisen with respect to the use of entity-specific assumptions, rather than market participant assumptions, to measure the fair value of non-financial assets under FASB Statements No. 141, No. 142, *Goodwill and Other Intangible Assets*, and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Appendix A of this paper summarises the FASB's discussions to date in that project.

8. The Boards received several comments on the proposals related to assembled workforces, in-process research and development (IPR&D), and reacquired rights. The staff plans to address those issues at the October Board meetings.

SUMMARY OF QUESTIONS FOR THE BOARDS

9. *Do the Boards agree that intangible assets should be recognised separately from goodwill (assuming that there is a relevant and reliable measurement attribute)? (paragraph 40)*
10. *Do the Boards agree that identifiable intangible assets acquired in a business combination should be measured at market value or do the Boards want the staff to explore an entity-specific measurement attribute? (paragraph 51)*
11. *Do the Boards believe that guidance on the initial and subsequent measurements of assets that an entity does not intend to use should be provided as part of the business combinations project? (paragraph 52)*
12. *Do the Boards agree that a fair value measurement of an identifiable intangible asset is sufficiently reliable if it is based on inputs in Levels 1, 2 or 3 of the fair value hierarchy? (paragraph 68)*
- If not, how do the Boards want to define sufficient reliability for recognising identifiable intangible assets separately from goodwill? (paragraph 69)*
13. *Do the Boards agree that identifiable intangible assets acquired in a business combination always can be measured at market value with sufficient reliability to be recognised separately from goodwill? That is, do the Boards agree that inputs in Levels 1, 2 or 3 of the fair value hierarchy always will be available for intangible assets that are identifiable? (paragraph 74)*

14. *If the Boards do not agree that all identifiable intangible assets can be measured at market value with sufficient reliability to be recognised separately from goodwill, should identifiable intangible assets that cannot be measured with sufficient reliability be:*

- a. *subsumed in goodwill;***
- b. *aggregated in a unit of account that can be measured reliably at market value; or***
- c. *measured using a measurement attribute other than market value? (paragraph 79)***

15. *Based on cost-benefit considerations, do the Boards want the staff to explore an exception from fair value measurement for intangible assets acquired in a business combination? (paragraph 84)*

If so, should the exception permit entities to use their own assumptions for measurements of intangible assets in Level 3 of the fair value hierarchy, even if market participant assumptions are available without undue cost and effort or if there are contrary data indicating that market participants would use different assumptions or should a different exception be made? (paragraph 85)

Should the exception be limited to intangible assets or should it apply to other non-financial assets? (paragraph 86)

SECTION 1—BACKGROUND INFORMATION AND COMMENT LETTER SUMMARY

COMPARISON OF BC ED PROPOSAL WITH EXISTING GUIDANCE

16. The following table provides a high-level comparison of the guidance proposed in the BC ED and the existing guidance in IFRS 3 and Statement 141.

	IASB BC ED	FASB BC ED	IFRS 3	STATEMENT 141
Criteria for recognition of intangible assets separately from goodwill	<p>Separate recognition of intangible assets that meet the definition of an intangible asset in IAS 38.</p> <p>IAS 38 defines an <i>intangible asset</i> as ‘an identifiable non-monetary asset without physical substance’.</p> <p>The IAS 38 (paragraph 12) definition of <i>identifiable</i> is the same as that proposed in the BC ED (see next column).</p> <p>An <i>asset</i> is defined in IAS 38 (and the IASB’s <i>Framework</i>) as ‘a resource: (a) controlled by an entity as a result of past events; and (b) from which future economic benefits are expected to flow to the entity’.</p>	<p>Separate recognition of intangible assets that are identifiable.</p> <p>Paragraph 3(k) of the BC ED states that an asset is <i>identifiable</i> if it either:</p> <p>(1) is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, asset, or liability, regardless of whether the entity intends to do so; or</p> <p>(2) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.</p>	<p>Consistent with IASB BC ED, except includes an additional reliable measurement criterion (see below). Paragraph 45 of IFRS 3 states ‘...the acquirer recognises separately an intangible asset of the acquiree at the acquisition date only if it meets the definition of an intangible asset in IAS 38 <i>Intangible Assets</i> and its fair value can be measured reliably.’</p>	<p>Same two criteria for separate recognition as FASB BC ED (arising from contractual-legal rights or separable), but those two criteria are stand-alone criteria to establish reliable measurement, rather than part of the definition of <i>identifiable</i> (which is not defined in Statement 141).</p>
Reliability	Incorporated into the criteria for separate recognition of intangible assets (see above). The Boards concluded that if an		States that in addition to being <i>identifiable</i> , an intangible asset	Consistent with BC ED.

	IASB BC ED	FASB BC ED	IFRS 3	STATEMENT 141
criterion	intangible asset is <i>identifiable</i> , sufficient information always will exist to measure reliably its fair value.		must be <i>measured reliably</i> to be recognised separately from goodwill. Paragraphs 35-41 of IAS 38 provide guidance for determining whether fair value can be measured reliably.	
Measurement attribute	Fair value defined as ‘the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties’. The BC ED also notes that this definition is based on the definition in the FASB’s <i>Fair Value Measurements</i> (FVM) ED and might change in the final FVM standard. In redeliberations, the FASB has revised the definition of <i>fair value</i> to be ‘the price that would be <i>received to sell</i> an asset or <i>paid to transfer</i> a liability in an orderly transaction between market participants at the measurement date’.		Fair value defined as ‘the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction’.	Fair value defined as ‘the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale’.
Additional guidance	Provided in paragraphs A27-A61 of the BC ED.		Provided in the Illustrative Examples in IFRS 3, which are reflected in paragraphs A27-A61 of the BC ED.	Provided in paragraphs A10-A28 of Statement 141, which are very similar to paragraphs A27-A61 of the BC ED.

PREVIOUS BOARD DELIBERATIONS IN PHASE II OF THE BC PROJECT

17. In Phase II of the Business Combinations project, the Boards carried forward without reconsideration the notion of *identifiability* for recognising intangible assets separately from goodwill and the fair value measurement attribute for intangible assets. Reliable measurement of intangible assets was identified as a convergence issue during the drafting of the joint BC ED. The issue was discussed at the following meetings:
- a. The IASB's 15 February 2005, 15 December 2004 and 17 November 2004 meetings.
 - b. The FASB's 24 November 2004 meeting.
18. In November and December 2004, the Boards attempted to converge on this issue, but each Board reaffirmed its earlier conclusion. That is, the FASB decided not to include an additional requirement that the fair value of an intangible asset must be able to be measured reliably to be recognised separately and the IASB decided to retain the reliable measurement criterion in IFRS 3 and IAS 38.
19. As noted in the minutes from the FASB's 24 November 2004 meeting, FASB members expressed the following reasons for not including an additional requirement that the fair value of an intangible asset must be able to be measured reliably to be recognised separately from goodwill:
- a. Paragraph 39 of Statement 141³ provides indicators of reliable measurement and adequately describes the criteria (arising from contractual-legal rights or separable) needed to separately recognise an intangible asset. The FASB developed the separate recognition criteria for intangible assets in Statement 141 to deal expressly with the issue

³ Paragraph 39 of Statement 141 states:

An intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired entity or from other rights and obligations). If an intangible asset does not arise from contractual or other legal rights, it shall be recognized as an asset apart from goodwill only if it is separable, that is, it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so). For purposes of this Statement, however, an intangible asset that cannot be sold, transferred, licensed, rented, or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset, or liability.

of whether an intangible asset can be measured with sufficient reliability. The FASB concluded that assets meeting either of the criteria, when acquired in business combination, could be measured reliably.

- b. An active marketplace, history or evidence of an exchange transaction for the same or a similar asset, are unnecessary to measure reliably the fair value of an asset (or liability).
- c. The phrase “would be dependent on immeasurable variables” included in paragraph 38 of IAS 38 relative to determining whether an intangible asset can be measured reliably might not be operational.
- d. Furthermore, “immeasurable variables” seems to refer to the third tier of fair value measurement in the fair value hierarchy (with entity inputs). An exception should not be provided for separate recognition of intangible assets, when separate recognition of other assets (and liabilities), that might also require significant entity inputs or be more difficult to measure reliably, is required in the BC ED (for example, contingencies).
- e. Describing the characteristics of a separately recognised intangible asset, rather than the method for determining when to separately recognise an intangible asset, is a superior approach.
- f. It is not satisfactory that if reliable measurement is required and an intangible asset could be judged not to be measured reliably, the value of the intangible asset will be embedded in goodwill, an indefinite-lived intangible asset.
- g. The Exposure Draft that led to Statement 141 initially required that intangible assets must be identifiable and able to be measured reliably in order to be separately recognised, and based on comments received the FASB removed the reliable measurement criterion.
- h. In addition some FASB members were concerned that if they were to allow a measurability exception without demonstrable evidence of such a need that might undermine the FASB’s efforts on the fair value measurements project.

20. In initial deliberations of Phase II of the Business Combinations project, IASB members noted that in field visits and round-table discussions held as part of the IASB’s consultative process in developing IFRS 3 and the revised IAS 38, participants provided numerous examples of intangible assets they had acquired in business combinations whose fair values might not be able to be measured reliably. After considering those comments, the IASB concluded that, in some situations, there might not be sufficient information to measure reliably the fair value of

intangible assets separately from goodwill when those intangible assets arise either:

- a. from legal or other contractual rights and are not separable (ie could be transferred only as part of the sale of a business as a whole); or
- b. from legal or other contractual rights and are separable (ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability), but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would be dependent on immeasurable variables.

21. Several IASB members noted that the issue raised by constituents was not that it was not possible to measure intangible assets reliably at fair value, but rather that it was not possible to separate the intangible assets because the cash flows were not separate. Several IASB members suggested they would not object to removing the reliable measurement criterion if the guidance specified that intangible assets with joint cash flows can be grouped together for recognition and measurement purposes.

22. In February 2005 the IASB decided for the sake of convergence to remove the reliability of measurement criterion and converge with Statement 141. The IASB also decided that the joint Exposure Draft should ask constituents to address this issue to obtain feedback on whether there is evidence of particular circumstances other than an assembled workforce in which the fair value of an intangible asset might not be capable of being measured reliably separately from goodwill.

23. One IASB member expressed an alternative view on the decision to remove the reliable measurement recognition criterion for intangible assets acquired in a business combination. Paragraphs AV19 and AV20 of the IASB ED state:

AV19 It is acknowledged that reliability of measurement is 'a criterion for recognition in the *Framework*' (paragraph BC98). Its absence from the draft revised IFRS 3 is supported by the claim that 'separate recognition of intangible assets, rather than subsuming them in goodwill, provides better information to users of financial statements, even though a significant degree of judgement could be involved in determining that fair value' (paragraph BC102). This statement is unsupported by evidence, and overriding the *Framework* in this way creates the possibility of serious inconsistencies in the reliability of different components of financial statements. This is particularly the case because, once the reliability criterion is removed, there is no limit to

the unreliability of measurements which may be reported for separate intangible assets acquired in a business combination.

AV20 The draft revised IFRS 3 acknowledges only one example in which measurement is sufficiently unreliable to justify non-recognition—the case of an assembled workforce. The Board member does not believe this is the only possible example of measurement unreliability that should preclude separate recognition. Indeed, the responses to ED 3, the Exposure Draft that preceded IFRS 3, suggested that in many cases the measurement of acquired intangible assets is extremely unreliable.

SUMMARY OF COMMENT LETTER RESPONSES

24. The BC ED (Question 16) asked respondents:

Do you believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill? If not, why? Do you have any examples of an intangible asset that arises from legal or contractual rights and has both of the following characteristics:

- (a) the intangible asset cannot be sold, transferred, licensed, rented, or exchanged individually or in combination with a related contract, asset, or liability; and*
- (b) cash flows that the intangible asset generates are inextricably linked with the cash flows that the business generates as a whole?*

25. The majority of respondents disagreed that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill. Those respondents' comments can be summarised as follows:

- a. Because active markets are expected to be uncommon for intangible assets, there will likely have been no, or only a few, past exchange transactions on which to base a fair value measurement. This will require preparers to estimate the price in a hypothetical exchange transaction, therefore reducing the reliability of the measurement.
- b. It will be extremely difficult to determine the fair value of intangible assets without using valuation techniques. Some respondents questioned whether valuation techniques result in reliable information because they are subjective and rely on estimates and significant judgement, and involve various assumptions, which can dilute measurement reliability.
- c. An identifiable intangible asset might not be able to be measured reliably if the cash flows/economic benefits that it generates are linked to the cash flows/economic benefits generated by the business as a whole.

- d. Some identifiable intangible assets are not transferable without third party consent or regulatory approval. Some might also legally be prohibited from being sold or transferred (such as those containing personal information about an entity's customers).
- e. The proposal is inconsistent with the IASB's *Framework*, which requires reliability of measurement for the recognition of an asset. The IASB should not depart from the *Framework* without due process solely for convergence purposes. Some constituents concurred with the alternative view expressed in the IASB's BC ED (paragraph AV19), which states that once the reliability criterion is removed, there is no limit to the unreliability of measurements that may be reported for separate intangible assets acquired in a business combination.

26. Respondents also identified a number of specific examples of intangible assets that they believe might not be able to be measured reliably. In Appendix B, the staff explains how those intangible assets are valued in practice.

27. A minority of respondents agreed that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill. Those respondents:

- a. agreed with the Boards that recognising identifiable intangible assets separately from goodwill provides users of financial statements with better information than subsuming them in goodwill.
- b. stated that entities should not be able to avoid the separate recognition of intangible assets simply because it is more difficult to measure their fair values.
- c. expressed concern about the potential for non-amortisation of finite-lived intangible assets if they are subsumed in goodwill.

However, several of those respondents suggested that the Boards should provide additional guidance on how to measure the fair values of identifiable intangible assets acquired in a business combination.

SECTION 2—STAFF ANALYSIS

28. Through discussions on the FASB’s project on a proposed FSP on the measurement of non-financial assets, the staff has become aware that some FASB members question the relevance and reliability of fair value as a measurement attribute for non-financial assets that are measured using significant unobservable inputs (ie Level 3 measurements in the FASB’s fair value hierarchy). In addition, some FASB members have questioned whether the benefits of measuring identifiable intangible assets in Level 3 of the fair value hierarchy exceed the costs of added valuation complexity when an observable market does not exist
29. The staff believes that it is important to separate discussions about the relevance and reliability of fair value as a measurement attribute for intangible assets from cost-benefit considerations. That is because the staff believes that it is important to identify the appropriate measurement attribute on a conceptual level and that cost-benefit considerations are a constraint in financial reporting. If the Boards decide for cost-benefit reasons to require or permit the use of a measurement attribute that is not the most relevant attribute, the staff believes that the basis for that decision should be explained clearly in the final standard.
30. Therefore, the staff has structured this analysis as follows:
- a. Issue A—Should intangible assets be recognised separately from goodwill?
 - b. Issue B—Should a market value or an entity-specific value be used to measure intangible assets?
 - c. Issue C—Can the market value of identifiable intangible assets be measured reliably?
 - i. Sub-Issue C1—Meaning of *sufficient reliability*
 - ii. Sub-Issue C2—Can all identifiable intangible assets be measured reliably?
 - iii. Sub-Issue C3—Alternatives if Boards decide that some identifiable intangible assets might not be able to be measured reliably at market value
 - d. Issue D—Do the benefits of recognising identifiable intangible assets at fair value outweigh the costs?

Issue A—Should Intangible Assets be Recognised Separately from Goodwill?

31. This section considers whether intangible assets should be separated from goodwill. To simplify and focus the discussion, we assume that a relevant and reliable measurement attribute exists. Issues B and C address relevance and reliability, respectively.
32. In developing Statement 141 and IFRS 3, the Boards decided for the following primary reasons to provide guidance for determining whether an acquired intangible asset should be recognised apart from goodwill (as described in paragraph BC101 of IFRS 3 and paragraphs B148-B150 of Statement 141):
- a. intangible assets make up an increasing proportion of the assets of many (if not most) entities.
 - b. despite the provisions in IAS 22 *Business Combinations* and IAS 38 and APB Opinion No. 16, *Business Combinations*, that required that intangible assets acquired in a business combination be recognised apart from goodwill, the Boards observed that intangible assets acquired in a business combination often were included in the amount recognised as goodwill.
 - c. the decision usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill.
 - d. having explicit criteria that determine whether an acquired intangible asset should be recognised apart from goodwill was important to the decision that goodwill is an indefinite-lived asset that should not be amortised. In the absence of such criteria, many more finite-lived intangible assets would be included in the amount recognised as goodwill.
33. Several respondents to the BC ED supported strongly the recognition of intangible assets separately from goodwill, noting the importance of providing information about the intangible assets that were acquired as part of a business combination. In addition, in preparing this paper, the staff sought the input of financial statement users on the IASB's Analysts' Representative Group and the FASB's Business Combinations Resource Group. The staff asked the users:
- a. Do you agree with the Boards that an estimate of fair value and the separate recognition of intangible assets, rather than subsuming them

in goodwill, provides better information to the users of financial statements, even though a significant degree of judgement could be involved in determining those fair values?

- b. Do you treat separately recognised intangible assets differently than goodwill?

34. Responses from users were mixed. Some users agreed that the separate recognition of intangible assets provides better information to users of financial statements and noted that in their analyses they treat intangible assets differently than goodwill. [Remainder of paragraph omitted from observer note.]
35. Other users stated that the information provided by recognising intangible assets separately from goodwill might be useful in some, but not all, circumstances. Those users identified reliability and the costs of separate recognition of intangible assets as concerns. [Remainder of paragraph omitted from observer note.]
36. Several users stated that in their analyses they do not treat goodwill differently than separately recognised intangible assets. [Remainder of paragraph omitted from observer note.]
37. It is difficult to reconcile the different views expressed. It appears that some analysis techniques used by users incorporate information about separately recognised intangible assets and other techniques do not. The staff notes that if intangible assets are required to be recognised separately from goodwill, those users who use analysis techniques that do not separate goodwill from other intangible assets can aggregate or ignore the information if they choose to. However, if intangible assets are not required to be recognised separately from goodwill, those users who use analysis techniques that involve treating goodwill differently than other intangible assets will not have access to the information that they need to perform their analyses.
38. The staff believes that it will improve the decision usefulness of financial statements when assets with essentially different characteristics are presented separately. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* states:

Classification in financial statements facilitates analysis by grouping items with essentially similar characteristics and separating items with essentially different characteristics. Analysis aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows requires financial information segregated into reasonably homogeneous groups. For example, components of financial statements that consist of items that have similar characteristics in one or more respects, such as continuity or recurrence, stability, risk, and reliability, are likely to have more predictive value than if their characteristics are dissimilar. (paragraph 20)

39. In the staff's view, identifiable intangible assets have economic characteristics that are different from those of goodwill and presenting identifiable assets separate from goodwill is likely to improve the decision usefulness of financial statements. Therefore, the staff agrees with the Boards and those users that stated that the decision usefulness of financial statements is enhanced when intangible assets acquired in a business combination are distinguished from goodwill (assuming the intangible assets are measured at a relevant and reliable measurement attribute).
40. ***Do the Boards agree that intangible assets should be recognised separately from goodwill (assuming that there is a relevant and reliable measurement attribute)?***

Issue B—Should a Market Value or an Entity-Specific Value be Used to Measure Intangible Assets?

41. Both IFRS 3 and Statement 141 require intangible assets to be measured at fair value. The Boards carried over into the BC ED the fair value measurement attribute for intangible assets without reconsideration. In addition, the Boards already have agreed that the following measurement principle should be used as the basis for redeliberations of the final business combinations standard:

In a business combination, the acquirer measures each recognised asset acquired and each liability assumed at its acquisition-date fair value.

42. However, through recent discussions in the FASB's FSP project on the measurement of non-financial assets, the staff has become aware that some FASB members question the relevance of fair value as a measurement attribute for non-financial assets acquired in a business combination, with some FASB members suggesting that an entity-specific might be more relevant. The staff seeks the input of the Boards on whether we should explore further the use of entity-specific measurements for non-financial assets acquired in a business combination.

43. When an entity acquires an asset its initial carrying amount normally will be based on a value that reflects a market measurement. That is to say, although what the acquirer intends to do with the asset will influence the amount the acquirer is prepared to pay it is not the determinant of the market value of the asset. The acquirer will not be willing to pay more for an asset than its market value simply because it expects that its use of the asset will generate more value for the entity than the typical market participant. Likewise, an entity will not be able to purchase an asset for less than its market value if it will not be able to generate the value from the asset that a typical market participant would expect to generate.

44. In concept, all acquisitions of assets and groups of assets or net assets should be accounted for similarly. Acquisitions of businesses, therefore, should be accounted for in the same way as separate acquisitions of assets. Although there is no direct measure of each asset acquired and each liability assumed in a business combination, the objective is the same—to measure each asset and liability as if it had been acquired separately at the acquisition date.

45. The staff believes that considering an example where an entity acquires an asset that it does not intend to use or intends to use in a way that is not consistent with the asset's highest and best use is a useful way of considering whether a market value or an entity-specific value should be used. For example, assume that an entity acquires a competitor and intends to 'lock up' the competitor's brand because it believes this will increase the value of its own brand.
46. The staff notes that an acquirer's intentions not to use a competitor's brand do not change the market value of that brand at the acquisition date. The acquirer will have to pay the same amount for the brand as other market participants who might intend to continue using the brand.
47. The initial recognition and measurement of the brand should not differ because the brand was acquired as part of a business combination rather than as an individual asset. If the brand was acquired on a stand-alone basis outside of a business combination, an entity would recognise a separate intangible asset measured at the exchange price, even though the entity does not intend to use the asset.⁴ The answer should not change simply because the entity has the alternative of recognising part or all of the exchange price in goodwill when the brand is acquired as part of a business combination.
48. In addition, the staff believes that an acquirer cannot make the decision not to use an intangible asset until it has control over that asset. This is consistent with the Boards' previous decisions on assets held for sale and restructuring costs. If an entity's intentions are considered when measuring an intangible asset acquired in a business combination, then it is hard to argue that an entity's intentions should not be considered in accounting for assets held for sale and restructuring costs.
49. If the Boards believe that entity-specific value is more relevant than market value for assets that an entity does not intend to use, the staff believes that measurement attribute should be applied only for measurements subsequent to initial recognition of the business combination. That is to say, the impact of the

⁴ Under IAS 38 (paragraph 24), an intangible asset is measured initially at cost (an exchange value).

acquirer's decision not to use an asset should be reflected in the financial statements of the acquirer after the acquisition.

50. In summary, the staff believes that intangible assets acquired in a business combination should be recognised and measured at an acquisition-date market value, rather than at an entity-specific value.
51. ***Do the Boards agree that identifiable intangible assets acquired in a business combination should be measured at market value or do the Boards want the staff to explore an entity-specific measurement attribute?***
52. The staff has become aware that some entities are measuring the value of an intangible asset that they do not intend to use at zero, based on their entity-specific use of the asset. The FASB's FVM document will clarify how to measure the fair value of that intangible asset if other market participants also would 'lock up' the asset because that would maximise the value of the group of assets in which the intangible asset would be used (locked up)—that is, the asset has 'defensive value'. For example, the fair value of an acquired brand that an entity does not intend to use should reflect the price that would be received to sell the brand, assuming its use (locked up) with its complementary assets. In that case, the fair value measurement would assume that those complementary assets would be available to market participants.
53. The staff notes that in its FSP project on the measurement of non-financial assets, the FASB has considered providing guidance on the subsequent measurements of assets an entity does not intend to use. The FASB considered clarifying that a non-financial asset that will not be used by an entity but that has 'defensive value' should be tested for impairment as a component of the primary asset group whose value is enhanced by the asset.
54. The staff seeks input from the Boards on whether similar guidance should be included in the final business combinations standard.
55. ***Do the Boards believe that guidance on the initial and subsequent measurements of assets that an entity does not intend to use should be provided as part of the business combinations project?***

Issue C—Can the Market Value of Identifiable Intangible Assets be Measured Reliably?

Sub-Issue C1—Meaning of Sufficient Reliability

56. As noted recently in the Conceptual Framework project, different Board members, staff and constituents often mean different things when they say ‘reliability’. Statement 141 uses the notions of an intangible asset arising from contractual-legal rights or being separable to establish a reliability threshold for the separate recognition of intangible assets. The FASB decided that if an intangible asset is separable or arises from contractual-legal rights its fair value can be measured reliably.
57. IAS 38 incorporates the notions of ‘arising from contractual-legal rights’ or ‘being separable’ in the definition of an intangible asset, but also states that an intangible asset must be able to be measured reliably to be recognised separately from goodwill. IAS 38 (paragraph 38) identifies the circumstances in which an intangible asset might not be able to be measured reliably (when the asset is (a) not separable or (b) there is no history or evidence of exchange transactions for the asset or similar assets), but it does not specify what causes a measurement to be unreliable in those circumstances.
58. The staff believes that it is important to clarify the meaning of *sufficient reliability* in the context of measuring identifiable intangible assets acquired in a business combination. The staff recommends retaining the notion of *identifiability* (arising from contractual-legal rights or separable), but clarifying that the reason that those criteria provide a reliability threshold is that if an intangible asset is *identifiable*, inputs within Levels 1, 2 or 3 of the fair value hierarchy will be available and this will allow the estimate of fair value to satisfy the characteristics of reliability in the *Framework*.
59. Several respondents stated that the proposal to remove the reliable measurement criterion from IFRS 3 conflicts with the IASB’s *Framework*. The staff does not believe that the proposal is overriding the *Framework*. The staff agrees with those respondents that noted that the *Framework* requires that assets must be capable of

being measured reliably to be recognised. However, the BC ED is not proposing that an identifiable intangible asset should be recognised separately from goodwill even if it cannot be measured reliably. The BC ED also incorporates a reliable measurement criterion because it requires an intangible asset to be *identifiable* to be recognised separately from goodwill. The BC ED is stating that all *identifiable* intangible assets will be able to be measured reliably and thus should be recognised. This is because in initial deliberations the Boards decided that if an intangible asset is identifiable, sufficient information will be available to measure fair value reliably. The proposal is not creating a lower reliability threshold for intangible assets.

60. As noted in the comment letter summary, many respondents to the BC ED noted that active markets do not exist for most identifiable intangible assets. Respondents noted that this will result in the use of valuation techniques to measure identifiable intangible assets and expressed concern about the subjectivity and uncertainty involved in estimating the price in a hypothetical exchange transaction. For example, BDO (CL #162) stated, ‘We are not convinced that the use of valuation techniques results in reliable information.’
61. The staff acknowledges that there will be uncertainty in the timing and amount of the inflows related to intangible assets and notes that the uncertainty will be reflected in the fair value measurement of those assets. However, the staff believes that the uncertainty can be mitigated through disclosures, which will be discussed at a future Board meeting.
62. Accounting often involves making estimates. Reporting an estimated fair value is not objectionable merely because that amount represents an estimate rather than a precise measure. Paragraph 86 of the IASB’s *Framework* states:

The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs 31 to 38 of this *Framework*. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognised in the balance sheet or income statement.

63. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states:

As a result of uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgements **based on the latest available, reliable information**... The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. (paragraphs 32-33; emphasis added)

64. The staff notes that the fair value hierarchy in the FASB's FVM document extends beyond quoted prices in active markets for identical assets and liabilities (Level 1). Levels 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

65. The staff does not believe that an active market is necessary to measure reliably the fair value of identifiable intangible assets. The use of valuation techniques that are consistent with the objective of fair value measurements (ie that aim to develop an estimate of a market value for the intangible asset) also result in information that is sufficiently reliable to satisfy the qualitative characteristics in the IASB's *Framework* and the FASB's Concepts Statements.

66. An estimate of the fair value of an intangible asset is reliable when it is **based on the latest available, reliable information**. Reliability does not depend on the precision of the estimate, but rather it depends on the availability of reliable information on which to base the estimate. Therefore, if reliable information is available to enable entities to use valuation techniques to estimate the fair values of intangible assets, those intangible assets can be measured reliably. That is, the staff believes that if Level 1, 2, or 3 inputs are available, fair value measures that satisfy the qualitative characteristics in the *Framework* can be estimated.

67. Alternatively, the Boards might decide that identifiable intangible assets must be able to be measured with a higher level of reliability than that imposed by the *Framework*. For example, the Boards might decide that Level 3 inputs are not sufficiently reliable to be used to measure identifiable intangible assets acquired in

a business combination. In that case, the staff does not believe that all identifiable intangible assets will be able to meet the higher reliability threshold because, as noted earlier, many intangible assets are not exchanged in observable markets. The Boards will have to decide how those intangible assets that cannot be measured at Levels 1 and 2 of the fair value hierarchy should be treated (see Sub-Issue C3).

68. *Do the Boards agree that a fair value measurement of an identifiable intangible asset is sufficiently reliable if it is based on inputs in Levels 1, 2 or 3 of the fair value hierarchy?*
69. *If not, how do the Boards want to define sufficient reliability for recognising identifiable intangible assets separately from goodwill?*

Sub-Issue C2—Can all Identifiable Intangible Assets be Measured Reliably?

70. The staff notes that, in January 2005, the FASB asked the SEC staff whether they were aware of specific practice problems that would warrant introducing the IFRS 3 reliable measurement recognition criterion for intangible assets into Statement 141. The SEC staff did not identify any measurement concerns and encouraged FASB members not to introduce an additional reliable measurement criterion, noting that it might be used inappropriately to subsume intangible assets in goodwill.
71. As noted in the summary of comment letters, respondents identified several situations in which they believe that the identifiable intangible assets might not be able to be measured reliably. However, respondents in the valuation industry stated that all identifiable intangible assets can be measured reliably at fair value.
72. The staff agrees with respondents from the valuation industry that all identifiable intangible assets can be measured with sufficient reliability to be recognised separately from goodwill. That is, the staff believes that sufficient information always will exist to permit reliable measurement of identifiable intangible assets at market value. This is based on the staff's understanding of the meaning of *sufficient reliability*. As noted in the analysis of Issue C1 of this paper, if the Boards decide to define a higher reliability threshold for intangible assets acquired in a business combination, the staff does not believe that all identifiable intangible assets will be able to be measured reliably. This is because many intangible assets are measured using Level 3 inputs.
73. In Appendix B, the staff explains why it disagrees with the respondents that do not agree that an intangible asset that is identifiable can always be measured with sufficient reliability to be separated from goodwill. Appendix B provides a detailed analysis of how the intangible assets identified by respondents as not being able to be measured reliably are actually measured in practice.

74. Do the Boards agree that identifiable intangible assets acquired in a business combination always can be measured at market value with sufficient reliability to be recognised separately from goodwill? That is, do the Boards agree that inputs in Levels 1, 2 or 3 of the fair value hierarchy always will be available for intangible assets that are identifiable?

Sub-Issue C3—Alternatives if Boards Decide that Some Identifiable Intangible Assets Might Not be Able to be Measured Reliably at Market Value

75. If the Boards decide that some identifiable intangible assets might not be able to be measured at market value with sufficient reliability, the Boards will need to decide how those intangible assets should be treated. The staff considered the following alternatives:

- a. Alternative A—Subsume the intangible assets in goodwill.
- b. Alternative B— Aggregate the intangible assets into a group that can be measured reliably at market value.
- c. Alternative C—Measure the intangible assets at a measurement attribute other than market value.

76. Alternative A is to subsume in goodwill those intangible assets that cannot be measured reliably at market value. If the Boards agree with the staff on Issue A (ie that separating intangible assets from goodwill provides more decision useful information), then the Boards might want to consider Alternatives B or C rather than Alternative A.

77. Alternative B is to provide guidance that would permit entities to aggregate individual intangible assets that cannot be measured reliably at market value into a group of assets that can be measured reliably at market value. For example, paragraphs B19 and B22 of Appendix B discuss the unit of account for water acquisition rights and easements. The final business combinations standard could include guidance similar to that in paragraph 36 of IAS 38, which states:

An intangible asset acquired in a business combination might be separable, but only together with a related tangible or intangible asset. For example, a magazine's publishing title might not be able to be sold separately from a related subscriber database, or a trademark for natural spring water might relate to a particular spring and could not be sold separately from the spring. In such cases, **the acquirer recognises the group of assets as a single asset separately from goodwill if the individual fair values of the assets in the group are not reliably measurable.** (emphasis added)

78. Alternative C is to measure those intangible assets that cannot be measured reliably at market value using a different measurement attribute. For example, entities could measure those intangible assets at an entity-specific value or a market-based value (such as that discussed as a possible exception to fair value measurement in paragraph 81).

79. If the Boards do not agree that all identifiable intangible assets can be measured at market value with sufficient reliability to be recognised separately from goodwill, should identifiable intangible assets that cannot be measured with sufficient reliability be:

- a. *subsumed in goodwill;*
- b. *aggregated in a unit of account that can be measured reliably at market value; or*
- c. *measured using a measurement attribute other than market value?*

Issue D—Do the Benefits of Recognising Identifiable Intangible Assets at Market Value Outweigh the Costs?

80. As noted in Issues B and C of this paper, the staff believes that market value is a relevant and reliable measurement attribute for recognising identifiable intangible assets acquired in a business combination separately from goodwill. However, the staff acknowledges that it might be difficult to measure the market value of intangible assets because observable markets often do not exist. In addition, the staff notes that some FASB members and constituents have questioned whether the benefits of measuring identifiable intangible assets in Level 3 of the fair value hierarchy exceed the costs of added valuation complexity when an observable market does not exist.
81. The staff seeks the Boards' input on whether, based on cost-benefit considerations, we should explore permitting an exception from fair value measurement for identifiable intangible assets acquired in a business combination. For example, the Boards might decide to permit, in circumstances where a fair value measurement would involve significant unobservable inputs (ie Level 3 of the fair value hierarchy), entities to use their own assumptions in the measurement of intangible assets that otherwise would be required to be measured at fair value. The acquirer would be permitted to use its own assumptions for such measurements, even if market participant assumptions are available without undue cost and effort or there are contrary data indicating that market participants would use different assumptions.⁵
82. If Board members believe that we should include an exception in the final business combinations standard, the staff seeks input on what alternative measurement attributes or treatments of intangible assets we should consider and whether the exception should be limited to intangible assets or whether it also should apply to other non-financial assets.
83. The staff has not analysed fully the costs and benefits of recognising identifiable intangible assets at market values separately from goodwill. If the Boards want

⁵ This exception is based on one of the alternatives considered in the FASB's FSP project on the measurement of non-financial assets.

the staff to explore an exception, we will bring that analysis back to a future meeting.

84. *Based on cost-benefit considerations, do the Boards want the staff to explore an exception from fair value measurement for intangible assets acquired in a business combination?*
85. *If so, should the exception permit entities to use their own assumptions for measurements of intangible assets in Level 3 of the fair value hierarchy, even if market participant assumptions are available without undue cost and effort or if there are contrary data indicating that market participants would use different assumptions or should a different exception be made?*
86. *Should the exception be limited to intangible assets or should it apply to other non-financial assets?*

APPENDIX A—SUMMARY OF THE FASB’S FSP PROJECT ON THE MEASUREMENT OF NON-FINANCIAL ASSETS

- A1. This appendix summarises the FASB’s discussions⁶ on a proposed FSP on the measurement of non-financial assets.
- A2. The FASB’s proposed FSP was discussed at its 28 June, 26 July, and 30 August 2006 Board meetings.
- A3. A number of reviewers of a draft of the FASB’s final Statement on fair value measurement expressed concern that the application of the market-participant approach in the draft Statement to non-financial assets and non-financial liabilities would change the existing measurement approach under Statements 141, 142, and 144. Those reviewers expressed significant concerns about the operationality of the guidance for the reporting entity to identify market participants and to use their assumptions in fair value measurements. Additionally, some reviewers stated that the measurement of a nonfinancial asset should reflect the manner in which that asset will be deployed in the entity’s operations rather than the manner in which that asset would be deployed by a market participant.
- A4. Although those comments were received in connection with the draft Statement, the requirement to use market-participant assumptions is currently specified in Statements 141, 142, and 144. However, certain language in those Statements might have caused some confusion about the requirement to use market-participant assumptions in fair value measurements, which has led to different interpretations in practice. Statements 141, 142 and 144 (and FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*) specify that, if a present value technique is used to measure fair value, estimates of future cash flows used in the technique shall incorporate assumptions that market participants would use in their estimates of fair value. If that information is not available without undue cost and effort, an entity may use its own assumptions. Statement 142 also specifies that when cash flows are used

⁶ The summary of the FASB’s discussions is based on the FASB’s minutes and summary of decisions reached for their 28 June, 26 July, and 30 August 2006 Board meetings.

to estimate fair value, those cash flows should be consistent with the most recent budgets and plans approved by management, which is an entity-specific notion. As a result, diversity in practice has arisen in the development of fair value measurements required under Statements 141, 142, and 144. At the June 28, 2006 meeting, the FASB decided to add a project to its agenda to address that diversity in practice.

- A5. At the FASB's 30 August 2006 Board meeting, the FASB decided that an FSP should be drafted to clarify the existing guidance related to fair value measurements in Statements 141, 142 and 144. The proposed FSP would be effective until the reporting entity adopts the fair value measurements Statement. Upon adoption of the fair value measurements Statement, the guidance therein would be applied in the circumstances addressed by the proposed FSP. The proposed FSP would not require application of the provisions of the fair value measurements Statement prior to a reporting entity's adoption of that Statement.

APPENDIX B--EXPLANATION OF HOW IDENTIFIABLE INTANGIBLE ASSETS ARE MEASURED IN PRACTICE

- B1. In this appendix, the staff explains why it disagrees with the respondents that do not agree that an intangible asset that is identifiable can always be measured with sufficient reliability to be separated from goodwill. This discussion is based on how the intangible assets identified by respondents are measured in practice.

Lack of an Active Market Resulting in the Use of Valuation Techniques

- B2. IAS 38 (paragraph 38) states that the only circumstances in which an intangible asset might not be measured reliably are when the asset is (a) not separable or (b) there is no history or evidence of exchange transactions for the asset (or similar assets). Therefore, the lack of an active market for intangible assets has provided some entities with a rationale to not recognise some intangible assets separately from goodwill for two main reasons:

- a. Entities often assert (based on (b)) that their intangible assets are sufficiently different from those of other entities (market participants) such that the 'reliably measurable' criterion cannot be met. The staff would argue that, in most cases:
 - i. similar assets have in fact been exchanged, or
 - ii. the fact that an asset (or similar asset) has not been exchanged does not mean that it cannot be.
- b. Level 1 inputs (quoted market prices) are rarely available in relation to intangible assets. The staff would like to point out that, in practice, sufficient Level 2 and Level 3 inputs are available. The valuation of intangible assets includes elements of market data (industry discount rates, benchmarking of industry growth and profitability, observed royalty rates, third party research reports) and some entity-specific (target company) data (historical financial data and cash flow projections), so that the fair values are based on a combination of Level 2 and Level 3 inputs.

- B3. Furthermore, the inclusion of a ‘reliably measurable’ criterion seems to have also provided entities with a rationale for not recognising intangible assets that they *do not know how to measure*. This rationale is inappropriately being used by entities as a basis for not recognising intangible assets separately from goodwill. The valuation expertise of the acquirer is not one of the criteria for reliable measurement. The fact that it is unclear to the acquirer how an asset should be valued separately from goodwill does not mean that they cannot find the expertise externally to do so. The staff does not agree that subsuming identifiable intangible assets into goodwill is an acceptable alternative.
- B4. Respondents raised concerns that valuation techniques and their underlying assumptions are subjective and, in some cases, arbitrary. Because of this, most of those respondents believe that the intangible assets are not reliably measurable and should therefore be subsumed within goodwill.
- a. Several respondents (during both phases of the business combinations project) indicated that non-contractual customer relationships are not reliably measurable because assumptions regarding customer loyalty, the ability to cross sell, competitor behaviour and other factors are subjective and in many cases arbitrary. Customer relationships are discussed in detail in paragraphs B24-B40.
 - b. One respondent raised a concern about the ability to measure reliably the future revenues associated with an existing third party loan servicing agreement. The entity has an existing contract with a third party under which the entity receives loan servicing fees. The pool of underlying loans changes over time, thereby affecting the level of servicing fees that will be received. In other words, they have an existing contract with a customer that provides for additional revenue to be generated based on market factors that are unknown and difficult to forecast. However, forecasts of market data are commonly made and at the very least historical data will be available from which to base a revenue forecast.

- c. Some respondents do not think that non-compete agreements are reliably measurable because they believe the required assumptions about competition and lost sales are subjective and arbitrary. Non-compete agreements are discussed further in paragraph B12.
 - d. Some respondents also claim that a reporting entity is misleading users of financial statements by including on the balance sheet the estimated fair value of these types of assets.
- B5. The objective is to estimate the fair value of the assets and liabilities acquired in an exchange transaction based on an estimate for an actual exchange (ie, the business combination). The valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to estimate the fair value of the assets and liabilities acquired.
- B6. The staff agrees that any valuation is subjective and debatable in both the methodologies and assumptions used. However, it is not arbitrary. The valuation of assets is part science (based on finance theory), part art (based on judgement) and relies on the best information available as of the acquisition date and the date the analysis is performed. In all cases, the calculated value is merely an estimate of the 'true' (unobservable, incalculable) value – but it is likely within a reasonable range of that value.
- B7. As discussed in Issue A of Section 2 of this paper, the staff queried users about how they use information about identifiable intangible assets. Some users questioned the reliability of the calculated values on the basis that the amortisation of some intangible assets might double-count the economic cost of maintaining the asset. [Remainder of paragraph omitted from observer note.]
- B8. That staff does not share the concern that double-counting occurs in this situation because, in the arriving at the fair value of the intangible asset, any costs necessary to maintain the asset are deducted in calculating the cash flows of the asset. In the customer list example, the marketing costs necessary to maintain the existing customer relationship are included in the cash flow

forecast.⁷ The fair value of the customer list asset is reduced accordingly, and the resulting amortisation expense is lower by that amount. This treatment is the same for other intangible assets as well, such as technology-related assets and the associated maintenance R&D costs.

Cash Flows and Economic Benefits are Linked to the Business as a Whole

B9. Several respondents gave examples of intangible assets that they do not think are separable from the cash flows of the business as a whole. These include:

- a. The brand name of an entity or of a product in a single product business
- b. Non-compete agreements
- c. Non-contractual customer relationships (discussed in paragraphs B24-B40)

B10. Almost by definition, all assets of a business are inter-related (ie, they form an integrated set of activities). This inter-relationship is generally considered to be a component of goodwill (ie, the synergies realised from using the assets together). This does not, however, mean that the assets are not separable from goodwill. Taken to the extreme, one could argue that a business would not exist without any of its intangible assets, such as the customers, the brand name or the technology, to name a few. In such a scenario, no intangible assets could be recognised separately from goodwill.

B11. The separability of a brand name (either of a product or an entity) is evidenced by brand name licensing transactions (for products, franchises, and, albeit less often, company names) and brand extensions. The brand name of an entity clearly contributes to the value of all of the entity's assets. However, in practice, a contributory asset charge for a brand (either for the entity or its products) is deducted from the cash flows of the other assets to ensure that the value of a

⁷ Note that the costs related to acquiring new customers are not included in the valuation of existing customer assets.

entity's brand is not double-counted in the valuation of the other assets.⁸ That is to say, the cash flows generated by the brand are separated from the cash flows generated by the other assets.

B12. Non-compete agreements between the entity and its key employees and/or the sellers are a part of many transactions. Although the valuation of an entity's non-compete agreements relies on the cash flows of the business as a whole, the staff does not believe that this intangible asset should be subsumed within goodwill. Non-compete agreements are valued as the difference between two scenarios: (1) the key employees do not compete with the entity, and (2) the key employees discontinue their employment and begin competing with the entity. Scenario 1 relies on the cash flows of the entity under a 'business as usual' assumption. Scenario 2, on the other hand, adjusts the 'business as usual' cash flows for assumptions regarding (a) the probability that the key employees will leave the entity and compete against it and (b) the amount of profits that will be lost by the entity if the key employees were to compete against it. The entity's overall cash flows (Scenario 1) are simply the means from which to determine the potential impact on the business if the non-compete agreement was not in place.

⁸ 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 in order 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.

The Asset is not Transferable in Isolation without Third Party Consent or Regulatory Approval or is not Transferable due to a Legal Prohibition on the Sale or Transfer of the Asset

B13. Several respondents gave examples of intangible assets that they do not think are reliably measurable because they are not transferable without third party consent or regulatory approval or there is a legal prohibition on the transfer of the asset.

These include:

- a. Licences that are essential to operate a business (such as a nuclear power plant or broadcast licences), but that cannot be sold separately from the business or transferred to another party
- b. Licences to operate that cannot be sold without the consent of a regulator and would be revoked in the case of a change of control of the current holder (such as a bank operating licence)
- c. Specialised rights (such as broadcasting or water acquisition rights) that are restricted from sale
- d. Distribution agreements which need the supplier's consent to transfer
- e. Easements that convey to one party non-transferable rights of access to the property of another party
- f. Customer lists in a regulated market where the ability to sell the list is prohibited or rendered ineffective by a prohibition on cold-calling

B14. The intangible assets listed above likely would not meet the criteria in IAS 38 for recognition because the intangible assets might not be reliably measurable because either (a) they are not separable or (b) there is no history or evidence of exchange transactions for the asset (or similar assets).

B15. The staff believes, however, that arguments that an intangible asset cannot be transferred in isolation or that another party must approve the transfer should not necessarily lead to the conclusion that the asset cannot be measured reliably. Restrictions on transfers should in fact be reflected in the fair value of the asset, not in the determination of whether or not an asset can be measured reliably (and consequently should be recognised).

B16. Although some intangible assets cannot be bought or transferred in the absence of a change in control, the restrictions on transfer do not negate the fact that an

intangible asset is identifiable, and therefore is reliably measurable. Clearly the identifiable intangible assets of the entity have value or the entity would not have been acquired and, in many cases, it is quite likely that the acquirer would have acquired some of the assets in isolation if it could have (rather than acquiring the whole entity).

B17. In many jurisdictions, business licences are necessary to operate. These licences are not transferable to third parties, and in the event of a change in control they might need to be reapplied for. Whether a business licence has value to the acquiring entity depends on the facts and circumstances. A business licence that is difficult to obtain will have a higher fair value than one that is relatively easy to obtain. Consider, for example, an entity that operates in a jurisdiction in which it is time consuming and costly to obtain a business licence. The acquiring entity would benefit from the fact that the licence is in place and the combined entity could operate from day one. In such a case, the licence has value and that value should be recognised. The fair value of such licences can be estimated in several ways, including (a) a market approach that takes into consideration the prices of comparable licences in the industry; (b) an income approach that estimates the cash flows generated with and without the licence; or (c) a cost approach that takes into account the cost to replace the licence.

B18. Entities that operate in regulated industries, such as banks, might require operating licences that are not transferable to third parties, even when there is a change in control. Because the licence will be cancelled as a result of the acquisition, a 'licence asset' has not been acquired and therefore should not be recognised. However, the staff thinks it is unlikely that an entity would acquire another entity that, as a result of the acquisition, would be required to cease operating. It is more likely that the entity would be acquired by an entity that has an operating licence in place.

B19. Some industry or specific company circumstances give rise to specialised rights. For example, processing plants often require water to operate and they are granted water acquisition rights by the government. The water acquisition rights clearly have value to the entity because it would not be able to operate without

them. However, it could be argued that a plant could be rebuilt in a different location with an available water supply, which would indicate that the water rights are no more vital to the business than the processing plant. It is likely that the fair value of the water acquisition rights can only be estimated by considering the contribution of other assets of the business. That is not to say that the rights should be subsumed into goodwill, but that the intangible asset might be related to a tangible asset (see also the discussion for easements below).

B20. Similarly, the communications industry relies on broadcasting rights or communications licenses granted by the government. The fair value of these rights and licenses can be estimated in several ways, including (a) a market approach that takes into consideration the prices of comparable rights/licenses in the industry; (b) an income approach that estimates the cash flows generated with and without the rights/licenses in place (a 'greenfield' approach); or (c) a cost approach that takes into account the cost to replace the rights/licenses.

B21. Distribution agreements with suppliers generally are not transferable to third parties, except in the event of a change in control. Whether a distribution agreement can be sold or transferred in isolation is different from whether it can be transferred as part of a business combination. Clearly, if consent is not given for the transfer in the event of a change in control, the agreement presumably will be cancelled and a 'distribution agreement asset' will not have been acquired and therefore should not be recognised. Restrictions on the transfer of an intangible asset will be reflected in the asset's fair value and do not affect whether its fair value can be measured reliably. Depending on the circumstances, the fair value of distribution agreements can be measured using an income approach similar to the approach used in the customer relationships discussion below. Alternatively, the fair value of these agreements might be best represented by considering whether or not the terms are at market rates. If it is determined that the agreement is on more favourable or less favourable terms to the market, the incremental profits or losses, respectively, will provide an indication of the fair value of the intangible asset.

B22. The fair value of the right to an easement is inextricably linked to the fair value of the real property to which it relates. It is quite common for an easement to not be transferable to a third party. This is irrelevant – an easement **on its own** does not have any value. In theory, the fair value of an easement could be measured by as the incremental difference between (1) the fair value of the property with the easement and (2) the fair value of the property without the easement. This might result in a large fair value of the easement (since the property value would be significantly lower should the easement not exist). In practice, easements are not valued in this manner and typically are included in the fair value of the acquired real property.

B23. In many jurisdictions, privacy laws prohibit an entity from selling information about its customers. However, this prohibition does not usually apply when there is a change in control. Whether a customer list legally can be sold in isolation is different from whether it can be transferred as part of a business combination. A prohibition on cold calling is less relevant when there are other means by which customers can be contacted (eg, via post or email). These restrictions would be reflected in the fair value of the customer list intangible asset and do not affect whether its fair value can be measured reliably. The fair value of a customer list can be measured using either (a) a market approach that takes into consideration the prices of comparable lists in the industry; (b) an income approach that estimates the cash flows generated by the customers; or (c) a cost approach that takes into account the cost to replace the list.

Customer Relationships

- B24. Although respondents were not asked specifically to comment on customer relationship intangible assets, many raised this as an issue that they believe needs to be addressed in the final business combinations standard.
- B25. Many respondents in both phases of the Business Combinations project have raised concerns that customer relationship intangibles are not separable from goodwill. They believe that only a contractual arrangement with customers can be measured reliably.
- B26. A customer relationship (as defined in Statement 141) exists if the entity has information about and has regular contact with the customer and the customer has the ability to make direct contact with the entity. In other words, they result from customer contracts or some other form of sale for which the entity obtains information about the customer (eg, the relationship one has with a mobile phone service provider after the initial contract period ends) and not those that arise from 'walk-in' situations (eg, frequenting a local café on the way to work every morning).
- B27. During Phase I, the respondents argued that assumptions regarding customer loyalty, the ability to cross sell, competitor behaviour, etc. are very subjective and in many cases arbitrary, meaning that a customer relationship asset cannot be measured reliably.
- B28. During Phase II, respondents have argued that customer relationships are not separable from the business because the cash flows generated from the customer relationships are inextricably linked to the cash flows of the business and, they believe, it follows that they are not separable from goodwill. They believe that only the contractual period can and should be measured.
- B29. One respondent in Phase II raised the issues that were brought up in Phase I, namely the uncertainty of 'significant variables [such as] customer loyalty, economic factors, pricing decisions, competition, etc.' that would make the values derived under such conditions unreliable. The respondent also questioned

whether it is possible to determine the useful life of a non-contractual customer relationship. In summary, the respondent believes that the ‘uncertainties involved in identifying, calculating and amortising such non-contractual customer relationship “intangible” assets [means] that they should be recognised as part of the goodwill on acquisition’.

B30. Another respondent believes that there is overlap in the various types of customer based intangibles, such as customer contracts, customer relationships, and order backlog.

B31. These comments can be categorised into three main issues:

- a. Whether customer relationships (in the absence of contracts) are separable from goodwill,
- b. Whether customer relationships can be measured reliably (ie, are the assumptions too subjective and arbitrary to provide a meaningful value?), and
- c. Whether there is any double counting in the valuation of customer-related intangible assets.

B32. To address the first issue, it is necessary to revisit the subject of separability.

Many respondents believe that the relationships an entity has with its customers are inextricably linked to business as a whole and therefore are not separable from goodwill.

B33. As stated previously, all assets of a business are inter-related. If the business would cease to exist without a particular asset, then no intangible assets would be considered to be separable from goodwill.

B34. To address the second and third issues, it is useful to return to the subject of measurement. The following are the main assumptions⁹ underlying a customer relationship valuation (assuming an income approach is used):

- a. Expected revenue from customers of the entity as of the acquisition date¹⁰ (for both existing and expected new products and services):
 - i. Contractual revenue (based on contracts currently in place) net of order backlog (see below), and
 - ii. Non-contractual revenue (including an estimate of contract renewals based on the probability that the contracts will be renewed and an estimate of customer attrition (or churn) rates); and
- b. Profitability of existing customers (excluding any costs related to acquiring new customers). This can be split by contractual and non-contractual if the profitability is different for each.
- c. Contributory asset capital charges to account for the utilisation of other assets in the generation of cash flows.

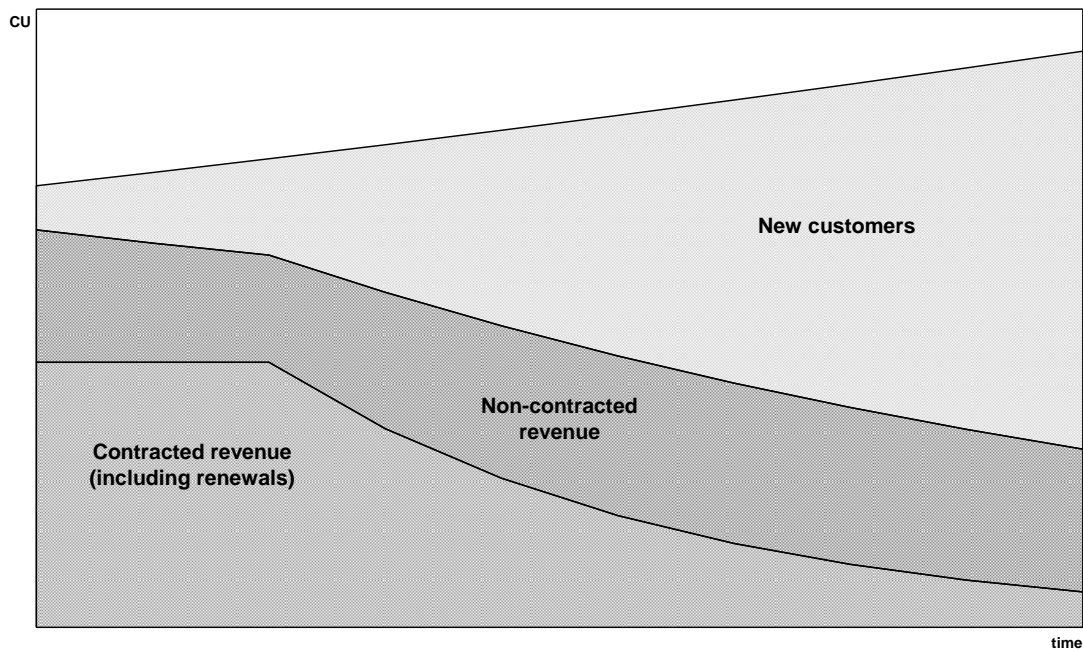
B35. The expected useful life of a customer-based intangible asset is implied from the attrition rate utilised. The attrition rate is meant to capture the loss of existing customers and the resulting revenues during a particular period, usually measured annually.¹¹

B36. The revenue stream of an entity's customers can be graphically depicted as:

⁹ These assumptions should be based on facts and circumstances existing and known as of the acquisition date.

¹⁰ These are referred to in this paper as 'existing customers'. The valuation of customer-related intangible assets should include only those customers that were (regularly) doing business with the entity as of the acquisition date.

¹¹ Attrition rates can be estimated from several sources, including the entity's historical attrition rates, the acquirer's historical attrition rates, and independent studies that analyse and publish attrition and retention rates for a particular industry.



B37. The contracted and non-contracted components of revenue (including contract renewals) are generated by existing customers for purchases of current and (currently known) future products and services. These components, when taken together, represent both the contracts in place and the relationships the entity has with its customers. The customer relationships are represented by the contract renewals and the non-contractual revenue. The aggregate of these revenue streams provides the basis for the valuation of the entity's existing customer contracts and relationships.

B38. The revenue generated from 'new customers' is subsumed into goodwill. These 'customers' are not currently doing business with the entity but there is an expectation that the entity, as a going concern, will acquire new customers over time. This category also includes the sales to existing customers of new products and services that have not yet been specifically identified, but which are included in the entity's long-term strategic plans (these might also reflect 'stretch targets').

- B39. Order backlog is a contract that results from purchase or sales orders for the entity's products and services.¹² Although order backlog is considered to be a contract that meets the contractual-legal criterion, it can be distinguished from a customer contract in that order backlog consists of orders that have formally been placed but for which the product or service has not yet been delivered and the revenue has not yet been received.
- B40. An example of order backlog would be a contract between an airline and an airplane manufacturer in which the airline has agreed to purchase 10 airplanes two years from today for CU5,000,000 each. A customer contract, on the other hand, would state that the airline will purchase 10 airplanes during two years, but does not specify when the airplanes will be delivered and it might or might not specify the price. In other words, a customer contract does not actually place a formal order.
- B41. The fair value of the order backlog is estimated based on the expected revenue to be received, less the costs to deliver the product or service. Contributory asset capital charges are deducted from the net income of the order backlog to estimate the cash flows attributable solely to the order backlog intangible asset. In the valuation of the entity's other intangible assets, the revenue and costs related to order backlog are excluded from ('backed out' of) the revenue and costs for the other intangible asset(s) to ensure there is no double counting of cash flows.

¹² EITF Issue No. 02-17, "Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination", states that purchase and sales orders should be considered to be contracts for the purposes of applying Statement 141. In addition, Example 3 of the illustrative examples of IFRS 3 states that purchase orders are considered to be contracts and meet the contractual-legal criterion.