

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

**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: December 2008, London

Project: Annual Improvements

Subject: Customer-Related Intangible Assets (Agenda paper 11G)

PURPOSE OF THIS PAPER

1. This paper summarises the IFRIC discussion of this issue at its November 2008 meeting. At this meeting, the staff will ask the Board to consider a recommendation made by the IFRIC that the Board review and amend IFRS 3R.
2. In light of the explicit guidance in IFRS 3R, as set out in the staff analysis reproduced in Appendix A to this agenda paper, the IFRIC decided that developing an Interpretation reflecting its conclusion is not possible. Noting widespread confusion in practice on this issue, the IFRIC decided that it could be best resolved by referring it to the IASB and the FASB with a recommendation to review and amend their respective business combination standards by
 - (a) removing the distinction between 'contractual' and 'non-contractual' customer-related intangible assets recognised in a business combination and focusing on the nature of the relationship rather than how it is established; and

- (b) reviewing the indicators that identify the existence of a customer relationship in paragraph IE28 of IFRS 3 and including them in the standard (IASB only).
- 3. Because IFRS 3R is a converged standard, the staff will also ask if the Board would like to consider this amendment proposal made by the IFRIC as a joint project with the FASB.

BACKGROUND

- 4. Appendices A and B reproduce the staff paper that included a summary of the request submitted to the IFRIC, the issue's background, and the staff analysis and recommendations presented to the IFRIC at its November 2008 meeting.
- 5. Appendix C sets out the relevant IFRIC Update from the November 2008 meeting.

SUMMARY OF IFRIC DISCUSSION IN NOVEMBER 2008

- 6. Some IFRIC members are practitioners in the US and noted that similar confusion existed under SFAS 141. The practice in the US that developed after the issuance of the clarification in EITF 02-17 is to recognize a non-contractual customer relationship intangible asset when it meets the definition of a 'customer relationship'. Consequently, there is no need to consider the separability criterion required for non-contractual relationships by IFRS 3R.
- 7. That same definition also exists under IFRS 3R. The location of that guidance, however, is in paragraph IE 28 of the Implementation Guidance. One possible solution could be for the Board to review the indicators that identify the existence of a customer relationship in paragraph IE28 of IFRS 3 and include them in the standard, as recommended by the IFRIC.
- 8. The staff agrees with the IFRIC's conclusions. How the relationship is established helps to identify whether a customer relationship exists but should not be the primary basis for determining whether the acquirer recognises an intangible asset. The existence of contractual relationships and information about a customer's prior purchases would be important inputs in valuing a customer relationship intangible asset but should not determine whether it is recognised.

9. Therefore, the staff agrees that removing the distinction between ‘contractual’ and ‘non-contractual’ customer-related intangible assets recognised in a business combination is a solution that reflects more consistently the nature of customer relationships and the underlying principle of asset recognition.
10. However, proceeding with this alternative will present a more fundamental change to the existing literature in this area that has been in place for several years under both US GAAP and IFRS. If so, this should be taken on as a joint project between the IASB and FASB.
- 11. Does the Board agree with the IFRIC recommendations in**
 - (a) **paragraph 2(a); and**
 - (b) **Paragraph 2(b)?**
- 12. Does the Board agree with the staff recommendation in paragraph 10?**

APPENDIX A – paper presented as Agenda paper 4 at IFRIC’s November 2008 meeting

PURPOSE OF THIS PAPER

13. This paper sets out the staff’s analysis of the possible scope for the project. The staff identified the following alternatives:
 - (a) Interpret the terms ‘contractual’ and ‘non-contractual’;
 - (b) Clarify the ‘separable’ criterion;
 - (c) Replace the conflicting ‘depositor’ relationship example with another ‘separable’ intangible that is truly ‘non-contractual’;
 - (d) Remove the ‘depositor’ relationship as an example of a ‘non-contractual’ but ‘separable’ intangible without replacing it;
 - (e) Remove the notion of a ‘non-contractual’ customer relationship as an identifiable intangible entirely from IFRS 3R and IAS 38.
14. This paper asks the IFRIC how it wishes to move forward on the issue and which of the identified alternatives it wishes the staff to develop further.

SUMMARY OF IFRIC DISCUSSION IN SEPTEMBER 2008

15. The IFRIC received a request to add an item to its agenda to provide guidance on the circumstances in which a non-contractual customer relationship arises in a business combination. Both IFRS 3 *Business Combinations* and IFRS 3R (as revised in 2008) require an acquirer to recognise the identifiable intangible assets of the acquiree separately from goodwill. An intangible asset is identifiable if it meets either the contractual-legal criterion or the separable criterion in IAS 38 *Intangible Assets*.
16. Customer relationship intangible assets may be either contractual or non-contractual. Contractual customer relationships are always recognised separately from goodwill as they meet the contractual-legal criterion. However, non-contractual customer relationships are recognised separately from goodwill only if they meet the separable criterion. Consequently, determining whether a relationship is contractual is critical to identifying and measuring both separately recognised customer relationship intangible assets and goodwill, and different conclusions could lead to substantially different accounting outcomes.
17. The staff analysis presented at that meeting includes a survey of IFRIC members. The questions and summarised responses from that survey indicated that diversity exists in practice regarding which customer relationships are considered to have a contractual basis and which are non-contractual. In addition, valuation experts may be taking different views, which could also be contributing to diversity in this area.
18. The IFRIC agreed with the staff's recommendation to add this issue to the agenda – not necessarily to develop an Interpretation but to explore whether IFRS 3 or IAS 38 needs clarification or improvement. Because IFRS 3 was the result of a joint project with the US Financial Accounting Standards Board (FASB), the IFRIC agreed that the staff should liaise with the FASB. The staff will also consider the deliberations of valuation professional organisations.
19. An extract from the September 2008 IFRIC Update is set out in Appendix A.
[DELETED]

STAFF ANALYSIS

20. Based on the submission and the IFRIC discussions at its September 2008 meeting, the staff considers the following issues:

- (a) Should 'contractual' or 'non-contractual' be clarified?
- (b) Can the separable criterion be met?
- (c) What do valuation professionals see in practice?
- (d) Has the FASB dealt with similar issues after issuing EITF 02-17?
- (e) What do the users think?

Should 'contractual' or 'non-contractual' be clarified?

21. The New Oxford Dictionary defines a *contract* as 'a written or spoken agreement, especially one concerning employment, sales or tenancy, that is intended to be enforceable by law.'

22. The Merriam-Webster's Dictionary defines a *contract* as 'a binding agreement between two or more persons or parties; especially: one legally enforceable.'

23. The IFRS Glossary defines a *contract* as:

.....an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

(IAS 32.13)

24. Under current IFRSs, the term 'contract' or 'contractual' appears in more than two-thirds of the standards issued, including IFRIC and SIC interpretations, relevant to a wide spectrum of accounting topics.

25. For example, aside from IAS 32 *Financial Instruments: Presentation*, in the staff's pre-ballot draft of the upcoming Discussion Paper for the proposed revenue recognition model, the joint IASB/FASB boards also define a contract consistently as '*an agreement between two parties that creates enforceable obligations*'.

26. This proposed definition for revenue recognition is consistent with a definition commonly used in the US for a ‘contract’, which is ‘*an agreement between two or more parties creating obligations that are enforceable or otherwise recognizable at law.*’ (*Black’s Law Dictionary*, 8th edition, page 341)
27. In contrast, the term ‘non-contractual’ appears in two standards and is not defined in the IFRS Glossary. In IFRS 3R, it refers to pre-existing relationships, contingencies, and identifiable customer relationship intangibles. In IAS 38, it is used solely in discussions related to customer relationships.
28. A legally enforceable contract may be written, oral, or implied (quasi). Some statutory requirements can be legally enforceable without an agreement from both parties.
29. However, the staff thinks that interpreting the term *contract* too broadly, based on the *legally enforceable* notion, is not as operable for the recognition of intangible assets as for performance obligations or general liabilities.
30. The notion of *legally enforceable* includes spoken and implied agreements, which could result in all relationships being ‘contractual’ assets, recognised at acquisition-date fair value. The staff does not think this is what the Board intended for asset recognition.
31. Adopting a narrower interpretation that limits a *contract* to only a written offer and acceptance is also problematic. The staff does not think it is operable when it comes to distinguishing intangibles that are non-contractual customer relationships for the following reasons.
32. Unlike customer lists, which are just specified information about a group of known customers, a customer relationship is something that adds value to the entity’s business not only today, but for a future period.
33. By default, a customer is someone who enters into a business transaction with the entity, which is the holder of that relationship asset on the date of acquisition. Almost always, the staff expects any business transaction involves a written offer and acceptance between the entity and its customer even though the document is only a sales receipt and the transaction is almost instantaneous.

34. For example, the staff thinks that the following could all be considered a written offer and acceptance between the customer and the entity:
- (a) an order for a grocery delivery sent over the internet,
 - (b) a sales receipt printed in the store for a walk-in cash purchase,
 - (c) a phoned in order from a catalogue,
 - (d) an agreement opening a bank deposit account,
 - (e) a utility or mobile service agreement, and so on.
35. Once the relationship is considered as a contractual-legal intangible, the standard requires the entity to consider expected renewals. The entity must consider the renewals on the date of acquisition even if a contract does not exist at that date or if the existing contract has a shorter remaining period than the expected renewal periods.
36. Because expected renewals are considered, the legally non-contractual portion of customer relationships established through prior contracts is already included in the value of contractually-based intangibles.
37. Therefore, even if the term *contract* is more narrowly interpreted as a written offer and acceptance, a truly *non-contractual* customer relationship may be limited only to prospective customers who have never purchased from the entity and to whom the entity actively marketed or contacted prior to the acquisition date in the attempt to secure a first order.
38. Some may view that this type of non-contractual customer relationships are similar to future revenues to be generated by new customers post-acquisition, and therefore, should not be recognized on the date of acquisition. See paragraph B38 in Appendix B to this paper.
39. Given the practice confusion on non-contractual customer relationships, and the relatively narrow use of the term in IFRSs, the staff thinks that some clarification would be helpful. However, at this point, the staff has not developed any recommendations. Input from the IFRIC would be helpful.

Can the separable criterion be met?

40. As set out in paragraph 2, non-contractual intangibles are recognised separately only if they meet an additional threshold, i.e., the *separable* criterion.
41. Appendix A of IFRS 3R defines an identifiable intangible asset as *separable* when it 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, identifiable asset or liability, regardless of whether the entity intends to do so.' [Emphasis added]
42. Valuation practitioners and companies have often asserted that customer relationships are difficult to measure reliably separately from goodwill and hence, they may not have been separated under the previous version of IFRS 3, which included an exception for reliable measurement.
43. The staff notes that 'reliable measurement' of identifiable intangibles was a convergence issue the Board considered when developing IFRS 3R and solicited comments at the ED stage. Although respondents were not asked specifically to comment on customer relationship intangible assets, many raised this as an issue that needed to be addressed.
44. An extract from the September 2006 IASB meeting specifically related to the comment letter analysis on customer relationships is set out in Appendix B to this paper.
45. The Board redeliberated respondents' comments and decided to remove from IAS 38 'reliably measured' as a recognition threshold to converge with US GAAP when IFRS 3R was finalised.
46. Previous guidance added to IAS 38 for non-contractual customer relationships when the Board finalised IFRS 3 in 2004 is still carried forward in IFRS 3R.
47. The staff notes that in paragraph BC13 of IAS 38 the Board explained that, in the absence of exchange transactions for the same or similar non-contractual customer relationships, such relationships acquired in a business combination would not normally meet the definition of an 'intangible asset' – they would not be separable, nor would the entity be able to demonstrate that it controls the expected future economic benefits flowing from that relationship.

48. Therefore, the Board clarified in paragraph 16 of IAS 38 that ‘*in the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the expected future economic benefits flowing from the customer relationships.*’ [IAS 38.16]
49. However, the staff doubts that any similar exchange transactions involving the type of non-contractual customer relationship described in paragraph 25 exist outside of a business combination, and did not attempt to search for evidence. The staff also questions how significant the value for this type of non-contractual intangible would be.
50. Assuming that the *separable* criterion could be met, an entity would recognise the non-contractual customer relationships with prospective customers.
51. If recognised, the staff questions whether the entity has enough available information about the success rate for converting these prospective leads into customers who buy from the entity to estimate a fair value and the useful life of the asset on the date of acquisition. The staff has the same questions about the attrition and expected renewal rates of these prospective customers.
52. The staff thinks that this type of non-contractual customer relationship could be an example where a reliable measurement distinct from goodwill is not available on acquisition date. Insufficient information for attrition or expected renewal rates also precludes an estimation of its useful life.
53. The staff thinks that the burden of proof that an exchange transaction is *capable* for such intangibles rests with the entity. That assessment could be arbitrary and subjective.
54. The staff also understands that in some jurisdictions, such as Australia, utility providers do not have contracts with their customers. The service is provided as required by statutory or regulatory requirements. When new competitors enter the market, customers of the incumbent may stay loyal to the incumbent or not change provider due to inertia.
55. If the incumbent is acquired, some suggest that this customer relationship may be a better example of non-contractual customer relationship intangibles. Although

some could also view this relationship as contractual because the monthly utility billings that specify the amount of service used by and the payment owed from the customer could be a form of written offer and acceptance.

56. As of the time of preparing this paper, the staff has not been able to verify whether any exchange transactions of such regulatory customer relationships exist outside a business combination.

What do valuation professionals see in practice?

57. The staff discussed with several valuation practitioners in the US and UK from two of the Big Four firms their experiences with non-contractual customer relationships. Though informal, some of the experiences shared with the staff include the following:

- (a) intangibles of significant values typically include trade names and contractual customer relationships (income valuation approach);
- (b) customer lists are of little value (cost replacement valuation approach), and non-contractual customer relationships (residual income valuation approach) are uncommon and not significantly valued;
- (c) a customer loyalty program was cited as an example of non-contractual customer relationship but mixed views on the value;
- (d) ‘depositor’ relationships and related deposit liabilities are not sold as a single asset group outside of business combinations;
- (e) ‘pay-as-you-go’ mobile customers are non-contractual but is that a *relationship* if mobile providers typically do not know the identity or contact details of the customers;¹
- (f) when non-contractual customer relationships are identified, often the entity has insufficient information for valuation to recognise them separately from goodwill.

¹ Paragraph IE28 of IFRS 3 states that a customer relationship exists between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer and (b) the customer has the ability to make direct contact with the entity. Customer relationships meet the contractual-legal criterion if an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the acquisition date. Customer relationships may also arise through means other than contracts, such as through regular contact by sales or service representatives.

58. The staff notes that customer relationships established through a customer loyalty program, a non-contractual example cited by valuation professionals, could also be considered contractual based on the views about walk-in sales discussed in paragraph 25.
59. In addition, the staff performed an informal search of public filings after 2002 for 10 registrants that disclosed customer relationship intangibles. The staff did not note any disclosure for significant non-contractual customer relationships.
60. The FASB has a Valuation Resource Group (VRG) comprised of representatives from preparers, auditors and the valuation community. The staff discussed with the FASB valuation staff and reviewed the list of issues deliberated but did not note any related to non-contractual customer relationships. The one issue deliberated by the VRG on customer relationships in a business combination relates to how to value overlapping customers when the acquirer already has pre-existing relationships with these customers.
61. The staff also notes that The Appraisers Foundation (TAF) in the US formed a working group to evaluate best practices for valuing customer relationships. At the time of preparing this paper, the staff is not aware of any TAF document related to this being published yet.

Has the FASB dealt with similar issues after issuing EITF 02-17?

62. The staff discussed the issue with the FASB staff assigned to coordinate with the IFRIC on this issue. The FASB staff shared that their Board will be reviewing a potential agenda proposal in November for an issue that deals with how to distinguish contractual and non-contractual pre-acquisition contingent liabilities.
63. SFAS 141R *Business Combinations* requires all contractual contingencies and all non-contractual contingencies that are more likely than not to give rise to an asset or liability as defined in Concepts Statement 6 to be recognized at their acquisition-date fair value.
64. This potential issue to be discussed by the FASB arose as a result of
 - (a) the different recognition thresholds for contractual and noncontractual contingencies under SFAS 141R

- (b) whether subsequent litigation costs should be included in the fair value on the date of acquisition
 - (c) questions about expected settlement costs that are ‘probable’ under SFAS 5 but not ‘more-likely-than-not’ to give rise to a liability defined in Concepts Statement 6
 - (d) concerns that derecognition of a liability for a contingency recognised as of the acquisition date takes place only when it is resolved
 - (e) subsequent litigation fees and whether those should be expensed as incurred, set up as a separate loss contingency, or reduced from the fair value of liability set up on the acquisition date
65. Despite the similarities in attempting to define what is contractual due to the different recognition thresholds in paragraph 45(a), the staff does not think that the two issues being reviewed by the FASB and the IFRIC require consideration of the same questions.
66. The IFRIC issue on intangible assets does not have the other issues in paragraph 52(b) – (e) related to contingencies that also affect the initial recognition on the date of acquisition.
67. Once recognised, measurement of the acquisition-date fair value is a valuation issue. Subsequent measurement and determining an appropriate useful life relate to Day 2 accounting. Unlike the contingencies, most intangible assets have finite lives and will always be derecognised once fully amortised.
68. It is premature to determine how the FASB will resolve the contingency issue before its Board meets to discuss it. The FASB staff proposed, among other things, adding a project to the FASB agenda to issue an FSP that amends SFAS 141R to retain the guidance in SFAS 141 related to the recognition and measurement of assets and liabilities arising from contingencies in a business combination.
69. The previous guidance in SFAS 141 did not distinguish between contractual or non-contractual contingencies. If adopted, the proposed FASB amendment will remove the notion of a non-contractual contingency in a business combination.

What do the users think?

70. The staff is aware that various users in the investor community have been publicly critical of the large number of intangibles currently being recognised separately from goodwill. A CRUF presentation at the April 2008 Joint IASB/FASB meeting included discussions about accounting for intangibles.
71. A common complaint is the double-counting of both the amortisation expenses and future expenses that the entity will incur to either grow new intangibles or maintain existing intangibles.
72. The users generally view that replacing goodwill amortisation with an annual impairment test based on fair value is an improvement to financial reporting. However, the large number of finite life intangibles recognised separately from goodwill is viewed as a 'back door' to goodwill amortisation. The staff note that this point was also made in our earlier survey of IFRIC members.
73. Unlike goodwill amortisation expenses, some users expressed the view that the intangibles amortisation expenses are harder to strip out when evaluating a company's operational performance.
74. In the context of customer relationships, the staff thinks that one way to consider how customer relationships create value to a business is through a customer's direct and indirect relationship with each of the business activities from input to output, that is, from placing an order to receiving the product or services delivered.
75. If so, the staff thinks there could be overlap in the value between a brand and a customer relationship, and possibly goodwill. That may explain why the valuation experts commonly use a residual approach to value these two assets. However, besides goodwill, these two assets have dramatically different useful lives - a longer one for a brand and a shorter one for customers.
76. The staff thinks that the differences between these two assets depends on the types of industry or business models.
77. For example, in a professional service industry, such as consultants or lawyers, a customer relationship may be purely with key personnel regardless of the brand. In a manufacturing industry, a customer relationship may also vary depending on its products, whether it's a commodity and transactional with price-sensitive

customers who purchase from several suppliers, or unique and protected with exclusive contracts that are renewed annually.

78. On the other hand, a brand's influence may extend beyond customers to recruitment and retention of staff, negotiation with suppliers, and positive perceptions by external stakeholders such as investors and government.
79. The staff thinks all of the above result in the diversity in practice and difficulty in the accounting for identifiable customer relationship intangibles.

POSSIBLE SCOPE OF THIS PROJECT

80. Based on the analysis above, the staff identified the following alternatives as the possible scope for the project:
 - (a) Alternative 1 – Interpret the terms ‘contractual’ and ‘non-contractual’;
 - (b) Alternative 2 – Clarify the ‘separable’ criterion;
 - (c) Alternative 3 – Replace the conflicting ‘depositor’ relationship example with another ‘separable’ intangible that is truly ‘non-contractual’;
 - (d) Alternative 4 – Remove the ‘depositor’ relationship as an example of a ‘non-contractual’ but ‘separable’ intangible without replacing it;
 - (e) Alternative 5 – Remove the notion of a ‘non-contractual’ customer relationship as an identifiable intangible entirely from IFRS 3R and IAS 38.

Pros and Cons

81. Alternatives 1 and 2 will require more lengthy discussions for the IFRIC to develop appropriate interpretations that clarify and improve the current financial reporting issue. In addition, both the IFRIC and the staff have to be mindful of the large amount of other accounting guidance that also considers a ‘contract’ to ensure that any proposed interpretations developed in the end will not result in unintended consequences to that guidance.
82. Alternatives 3 and 4 are sufficiently narrow in scope that the IFRIC should be able to reach a consensus timely on these compared to the others. Because these alternatives will require amendments to the standards, the Board also needs to deliberate and approve the IFRIC recommendations. Depending on the extent of the amendment, it could be a recommendation to the Annual Improvements

Process. However, even though both alternatives will improve financial reporting by removing a conflicting example, the staff does not think that they will remove the existing practice confusion when distinguishing contractual and non-contractual customer relationship intangible assets in a business combination.

83. Alternative 5 appears to be a solution that reflects more consistently the nature of customer relationships and the underlying principle of asset recognition. However, proceeding with this alternative will present a more fundamental change to the existing literature in this area that has been in place for several years under both US GAAP and IFRS. If so, this should be taken on as a joint project between the IASB and FASB.

QUESTIONS FOR THE IFRIC

- 84. Are there other alternatives not yet identified by the staff that the IFRIC would like to consider?**
- 85. Which of the alternatives identified would the IFRIC prefer as the scope for this project?**
- 86. If none of the above is a possible alternative for the scope of this project, how would the IFRIC like to proceed?**
87. Regardless of which alternative the IFRIC adopts, because IFRS 3R is a converged standard, the staff will continue to liaise with the FASB about the progress of this issue on a timely basis.

Appendix B – Paper presented as Agenda Paper 2B at the September 2006 IASB meeting

[IFRS 3R – COMMENT ANALYSIS]

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

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 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 assumptions² underlying a customer relationship valuation (assuming an income approach is used):

- a. Expected revenue from customers of the entity as of the acquisition date³ (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.

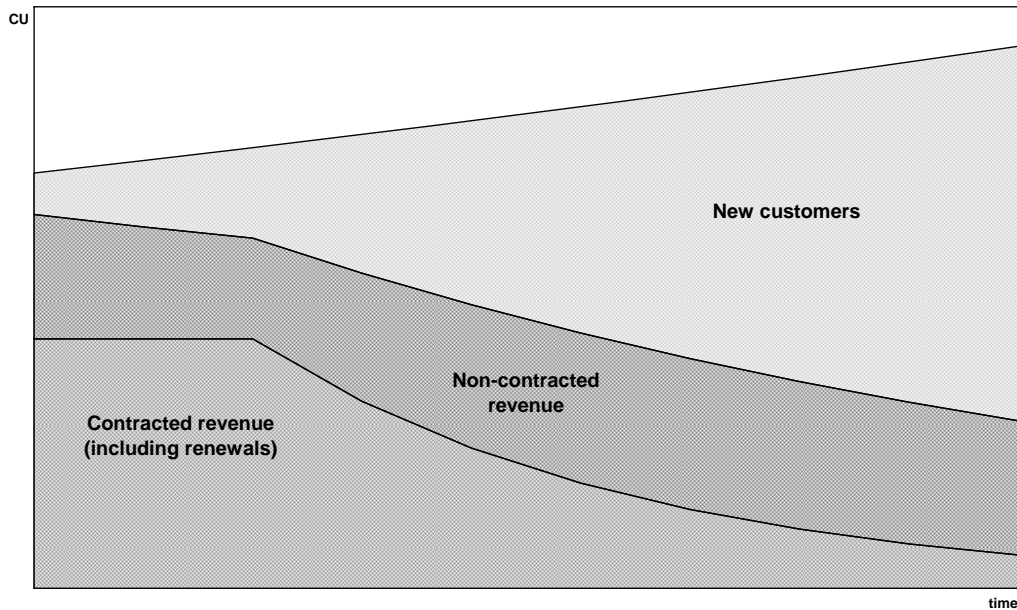
B35. The expected useful life of a customer-based intangible asset is implied from the attrition rate utilised. The attrition rate is meant to capture the loss of existing customers and the resulting revenues during a particular period, usually measured annually.⁴

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

² These assumptions should be based on facts and circumstances existing and known as of the acquisition date.

³ 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.

⁴ 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.⁵ Although order backlog is considered to be a

⁵ 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

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.

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.

Appendix C – RELEVANT IFRIC UPDATE (NOVEMBER 2008)

Customer-related intangible assets

The IFRIC received a request to add an item to its agenda to provide guidance on the circumstances in which a non-contractual customer relationship arises in a business combination. IFRS 3 *Business Combinations* (as revised in 2008) requires an acquirer to recognise the identifiable intangible assets of the acquiree separately from goodwill. An intangible asset is identifiable if it meets either the contractual-legal criterion or the separable criterion in IAS 38 *Intangible Assets*. Contractual customer relationships are always recognised separately from goodwill as they meet the contractual-legal criterion. However, non-contractual customer relationships are recognised separately from goodwill only if they meet the separable criterion.

The IFRIC noted that the IFRS Glossary defines the term ‘contract’. Paragraphs B31–B40 in the application guidance of IFRS 3 provide guidance on the recognition of intangible assets and the different criteria related to whether they are established based on a contract. The IFRIC also noted that paragraph IE28 in the illustrative examples accompanying IFRS 3 provides indicators for identifying the existence of a customer relationship between an entity and its customer and states that a customer relationship ‘may also arise through means other than contracts, such as through regular contact by sales or service representatives.’

The IFRIC concluded that how the relationship is established helps to identify whether a customer relationship exists but should not be the primary basis for determining whether the acquirer recognises an intangible asset. The IFRIC noted that the criteria in paragraph IE28 might be more relevant. The existence of contractual relationships and information about a customer’s prior purchases would be important inputs in valuing a customer relationship intangible asset but should not determine whether it is recognised.

In the light of the explicit guidance in IFRS 3, the IFRIC decided that developing an Interpretation reflecting its conclusion is not possible. Noting widespread confusion in practice on this issue, the IFRIC decided that it could be best resolved by referring it to the IASB and the FASB with a recommendation to review and amend IFRS 3 by:

- removing the distinction between ‘contractual’ and ‘non-contractual’ customer-related intangible assets recognised in a business combination; and
- reviewing the indicators that identify the existence of a customer relationship in paragraph IE28 of IFRS 3 and including them in the standard.