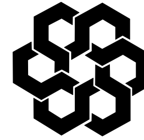

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International Accounting Standards Board

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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:	**December 2008, London**
Project:	**Fair Value Measurement**
Subject:	**Defensive intangible assets acquired in a business combination (Agenda paper 3A)**

Purpose of this paper

1 This paper addresses the fair value of intangible assets acquired in a business combination that the acquirer does not intend to use directly or intends to use in a way that is different from the way other market participants would use them ('defensive intangible assets').

Introduction

2 The *Fair Value Measurements* discussion paper did not specifically address defensive intangible assets. However, the staff has received questions from constituents about recognition, measurement and subsequent accounting for such assets. Furthermore, the FASB's Valuation Resources Group (VRG) and Emerging Issues Task Force (EITF) have discussed this topic. As a result, the staff thinks it is important that the Board address the recognition and measurement of, and the subsequent accounting for, defensive intangible assets in the fair value measurement project.

3 The staff notes, however, that IFRS 3 (issued in 2004) implicitly requires the recognition of defensive intangible assets, at least for trade names, and practice has addressed the initial measurement and subsequent accounting.

4 This paper is organised as follows:

Part 1: What is 'defensive value'?

Part 2: How is the fair value of a defensive intangible asset measured at initial recognition?

Part 3: How is a defensive intangible asset accounted for subsequently?

Part 4: Disclosure

Part 1: What is 'defensive value'?

5 Paragraph B43 of IFRS 3 (revised in 2008) states:

> For competitive or other reasons, the acquirer may intend not to use an acquired asset, for example, a research and development intangible asset, or it may intend to use the asset in a way that is different from the way in which other market participants would use it. Nevertheless, the acquirer shall measure the asset at fair value determined in accordance with its use by other market participants.

6 This is commonly referred to as a 'defensive intangible asset' and its measurement is commonly referred to as 'defensive value'.[1]

7 The previous IFRS 3 (issued in 2004) implicitly contains the concept of defensive intangible assets because the definition of fair value has a market participant focus. As a result, an acquiring entity recognises an intangible asset even if the acquirer does not intend to use that asset. The acquiring entity's intentions about the asset are reflected in the fair value of the asset only if that is what other market participants (knowledgeable, willing parties) would do. The staff understands that, in practice, this approach is commonly applied to trade names, but not always to other intangible assets (eg research and development assets).

8 Previously, FASB Statement of Financial Accounting Standards No. 141 *Business Combinations* (SFAS 141) did not have a similar concept. If an entity acquired an intangible asset in a business combination and did not intend to use that asset, the entity would not recognise it. In effect, it was subsumed into goodwill. The revised FASB business combinations standard (SFAS 141(R)) requires the recognition of a defensive intangible asset and its measurement is prescribed in FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157).

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[1] This description of a defensive intangible asset is slightly different from the definition in EITF 08-7 (see Appendix 2 to this Agenda Paper):

> An intangible asset acquired in a business combination or an asset acquisition that an entity does not intend to actively use but does intend to prevent others from using, has been commonly referred to as a "defensive asset" or a "locked-up asset" because while the asset is not being actively used, it is likely contributing to an increase in the value of other assets owned by the entity.

9 SFAS 157 states that an asset provides defensive value when it prevents an entity's competitors from accessing the economic benefits of the asset, thereby improving the prospects for the entity's own competing asset. Considering defensive value is part of the determination of an asset's highest and best use, which depends on its use by market participants.

10 The following table shows the three potential defensive value situations under SFAS 157 and IFRS 3 (revised in 2008):

	Situation 1	**Situation 2**	**Situation 3**
If reporting entity would…	lock-up or abandon the asset (if the reporting entity continues to use the asset, it is not a defensive intangible asset)	lock-up the asset	abandon the asset
…and market participants would…	continue using the asset	lock-up the asset to generate economic benefit for the market participants' own existing assets	abandon the asset (eg it does not earn a market rate of return or is unnecessary in the business)
…the highest and best use of the asset is to…	continue using the asset	lock-up the asset to generate economic benefit for other assets	abandon the asset
…and the fair value…	reflects the value of the asset as if it were being used (assuming market participants have complementary assets[2]). The fair value assumes continued investment in the asset.	reflects the value of the asset as if it were being locked up (assuming market participants have complementary assets). The fair value assumes no continued investment in the asset.	typically is nominal (and might be zero in many cases)

[2] Complementary assets are the other assets needed to generate economic benefits from the acquired asset. For a brand or trademark these might be the related trade name, formulas, recipes and technological expertise. Complementary assets are <u>not</u> the same as *competing* assets, which are the reporting entity's existing assets that are being protected by the fact that the reporting entity is locking up the acquired asset.

	Situation 1	Situation 2	Situation 3
An example:	Entity A acquires a research and development asset that it does not intend to complete. Other market participants would complete the project. The fair value would be determined based on the price that would be received in a current transaction to sell the project to a market participant who would complete the project.	Entity A acquires a research and development asset that it does not intend to complete. Other market participants also would lock up the project. The fair value would be determined based on the price that would be received in a current transaction to sell the project to a market participant who would lock up the project.	Entity A acquires a research and development asset that it does not intend to complete. Other market participants would discontinue the development of the project. The fair value would be determined based on the price that would be received in a current transaction to sell the project to a market participant who would abandon the project (which in this case is likely to be zero).

11 Economically, an acquirer's intention not to use an acquired competing intangible asset does not change the fair value of that asset at the acquisition date. The acquirer will have to pay the same amount (the fair value) for an asset as other market participants who, for example, might intend to continue actively using the asset.

Does it meet the definition of an asset?

12 Some think a defensive intangible asset in Situations 1 and 2 above does not meet the definition of an asset as defined in the Framework. These people assert that no future economic benefits are expected to flow to the entity by using that asset. By 'using', they mean generating direct cash flows by actively using the asset in the business.

13 The staff thinks this narrow definition of 'using' does not entirely capture the way benefits flow to an entity.

14 IFRSs define an asset as follows:

> An asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

15 The Framework describes future economic benefits as follows:

> …the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production. (Paragraph 53)

16 IAS 38 also describes future economic benefits:

> The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues. (Paragraph 17)

17 The receipt of benefits 'directly or indirectly' means that the asset does not necessarily need to generate cash flows directly (eg by actively using it in the business), but it can generate cash flows indirectly (eg by using it to protect the entity's other assets from competition).

18 The staff thinks that a defensive intangible asset meets the definition of an asset, consistent with the Board's decision in IFRS 3 (revised in 2008) to require the recognition of defensive intangible assets.

What is the asset?

19 Some wonder what the asset represents: is it the intangible asset that it would have been had it been used directly in the business? Or is it an asset that represents the protection it provides to the acquirer's other assets? Returning to the example in paragraph 10, the asset is a research and development asset in all three situations.

20 The staff thinks the reason the acquirer locks up an asset does not change what the asset is, although the reason might affect the measurement of the asset (see Part 2).

Part 2: How is the fair value of a defensive intangible asset measured at initial recognition?

21 Some wonder how to measure the fair value of a defensive intangible asset. Depending on the situation (see paragraph 10), the measurement might take into account different market participant assumptions. In Situation 1, the fair value of the asset reflects continued investment in that asset because market participants would continue to use it and, to do so, they would continually invest in the asset. In Situation 2, the fair value does not reflect continued investment because market participants would not be directly using the asset and they therefore would not invest in that asset. Regardless of the situation, the objective is to measure the fair value of the defensive intangible asset, not the indirect value to the reporting entity's (ie the acquirer's) existing assets (that is, it is not an entity-specific measurement).

22 The staff thinks the measurement of defensive intangible assets will depend on practice that has evolved under the current IFRS 3. That is, because this is not a new concept in IFRSs, and entities already recognise defensive intangible assets under IFRS 3, the measurement for entities applying IFRSs is not as big an issue as it might be, for example, for entities applying US GAAP.

23 Some also wonder which market participants should be used to determine whether a defensive intangible asset should be recognised, and, if it should be, which market participant assumptions should be used.

24 A common approach is to assume that a financial buyer (eg a private equity or venture capital firm) would acquire the asset (and its complementary assets) and continue to use it directly. However, it is important to consider the highest and best use that maximises the fair value of the asset, or asset group within which the asset is used. Even if the use of the assets within an asset group does not maximise the fair value of each of the assets individually, the highest and best use of the asset is the one that maximises the fair value of the assets as a group (see Appendix 1 for an example from SFAS 157 illustrating this point). In any event, the assessment of the highest and best use will be made from the perspective of market participants.

25 It is unlikely that there will be an observable market price (either a Level 1 or Level 2 input) for an intangible asset. Many of the inputs used to measure the fair value of an

intangible asset also will not be observable. In such situations, an entity must start with its own inputs, adjusting them only if there is information that is reasonably available that indicates that:

a market participants would assume something else; and/or

b the entity has special circumstances that are not available (without significant cost) to anyone else.

26 The entity therefore uses its own data to determine the fair value of the defensive intangible asset, making the necessary adjustments if it is reasonably knowable that market participants would make different assumptions.

Who are the relevant market participants for a defensive intangible asset?

27 Consider the following example:

> Entity X acquires a competitor, Entity Y. One of the identifiable intangible assets of Entity Y is a trademark of one of Entity Y's branded products. Since Entity X has a similar competing product, it does not intend to use that trademark post-acquisition. Entity X will rebrand Entity Y's product to the Entity X brand shortly after acquisition. Entity X therefore will 'lock up' the Entity Y trademark (ie Entity X will use the trademark defensively). The direct cash flows relating to the acquired trademark (ie revenues from the branded product) are expected to be nil.

28 Potential market participant buyers for Entity Y's trademark might include the following:

a market participants who would continue to use the trademark;

b market participants who would lock-up the trademark for defensive reasons because it has a competing asset of its own; and

c market participants who would abandon the trademark (or abandon it).

29 These market participants might be strategic (ie focused on the long-term fit within the acquiring entity's existing business) or financial buyers. It is likely that financial buyers would do (a) and strategic buyers would do (b) and (c). However, it is possible that financial and strategic buyers would do any of the above. In fact, some hold the

view that there is only one market and one relevant set of market participants: those who have the ability to buy the asset and who would maximise the value of the asset or asset group.

Market participants who would continue to use the asset (Situation 1)

30 Entity X must assess whether other market participants would continue to use the trademark, thereby maximising the value of the group of assets in which the trademark would be used. This might be the case if market participants, unlike Entity X, do not have similar branded products or have weaker brands. The fair value would be the price that would be received in a current transaction to sell the trademark to market participants who would use the trademark with its complementary assets as a group.

31 In this case, the market participant buyers would be prepared to pay for the Entity Y trademark up to an amount equal to the present value of the cash flows that the continued production of the trademarked goods would generate. The fair value of the trademark being used this way would reflect the continued production and sale of the trademarked goods, including the future investment necessary to maintain the asset's value.

Market participants who would 'lock up' the asset (Situation 2)

32 Entity X also must consider whether other market participants would maximise the value of their existing assets by locking up the trademark for competitive reasons. The fair value would reflect the price that would be received in a transaction to sell the trademark, assuming that market participants would lock up the trademark with its complementary assets as a group. The complementary assets might be the related trade name, formulas, recipes and technological expertise.

33 In this case, the market participants would be prepared to pay up to an amount equal to the value that the locked up trademark would contribute to their own competing branded products.[3] However, the objective is to measure the fair value of the defensive intangible asset, not the indirect value to the reporting entity's (ie the

[3] In fact, other market participants are already benefitting from the trademark being locked up. What they would be purchasing is a guarantee that the trademark will remain locked up given that Entity X currently has the ability to unlock the trademark if it chooses to do so.

acquirer's) existing assets. The fair value of the trademark being locked up this way would reflect the fact that the reporting entity and market participants would not continue to invest in the asset. But that does not mean the fair value is minimal or zero. The locked up asset's value reflects the indirect contribution to a market participant's other assets, whether or not it is being used directly. The staff thinks this is why SFAS 157 and IFRS 3 (as revised in 2008) address Situation 2—to acknowledge that an asset has value even if it is not being used directly.

34 The staff understands that Situation 2 is difficult to deal with in practice. Under current practice when applying IFRS 3 (as issued in 2004), an entity does not always recognise a locked up asset (or the entity would assume its fair value is minimal or zero) if it thinks market participants also would lock up the asset.

35 The notion that the fair value of a locked up asset reflects the indirect contribution to a market participant's other assets has led many to think that the valuation of the locked up asset would be based on the incremental cash flows generated by removing the intangible asset from the marketplace (ie an indirect measurement), and they wonder how to measure this without resulting in an entity-specific value.

36 The staff does not see Situation 2 as resulting in an 'incremental value' approach. The fair value of a locked up asset does not consider future investment in the asset (eg for a trademark, it would not assume future marketing and promotional investment), but it does consider the fact that a locked up asset might still have value even after it is taken out of the marketplace. It continues to have value even without direct investment in the asset, and indeed, it is not unheard of for assets to be taken out of the marketplace only to be reintroduced successfully later on.

Market participants who would abandon or sell the asset (Situation 3)

37 Finally, Entity X must consider whether other market participants would discontinue using the trademark, perhaps because it does not provide a market rate of return. The fair value would reflect the price that would be received in a transaction to sell the trademark standalone (which might be zero).

38 In this case, the acquired asset provides little, if any, benefit to a market participant buyer. A buyer would be prepared to pay only for the little benefit it might get from the asset or it will abandon the asset altogether to avoid making unnecessary losses.

Part 3: How is a defensive intangible asset accounted for subsequently?

39 This part addresses two issues:

a whether there is an immediate impairment of a defensive intangible asset and

b how to determine the appropriate amortisation period for a defensive intangible asset.

Is there an immediate full impairment of defensive intangible assets at acquisition when the asset is locked up?

40 Some think the impairment recognition criteria in IAS 36 will result in an immediate impairment loss since the expected cash flows relating to it are nil.

41 Paragraph 6 of IAS 36 states that the recoverable amount of an asset is the higher of its value in use and its fair value less costs to sell. The staff understands that current practice considers it reasonable that the fair value less costs to sell immediately after acquisition is not significantly different from the fair value at the acquisition, and therefore the asset is unlikely to be impaired immediately.[4]

42 However, even if there is no impairment on day 1 or day 2, how does an entity determine whether there is an impairment on day 365? Does the fact that the entity is not using the asset directly mean there is a 'triggering event'?

43 The 'triggering event' criteria in paragraphs 12 and 14 of IAS 36 do not appear to relate to defensive intangible assets under normal conditions (an adverse change in the business is a different issue).

44 On day 365 (and later) the asset is still being 'used' in the business. Assuming the defensive intangible asset does not have an indefinite useful life (as discussed in the following section) and is being amortised over the period over which the entity expects to generate economic benefits, and there has been no change in the expectations of those economic benefits (ie there has not been a 'triggering event'), there will not be an indication of impairment.

[4] This ignores the issue of whether the asset is impaired by its costs to sell immediately after initial recognition. That issue is outside the scope of this paper.

45 Furthermore, both value in use or fair value less costs to sell consider the cash flows generated from using the asset, whether the entity is generating cash flows directly or indirectly. The entity is using the asset because it provides protection for its existing assets. When measuring fair value less costs to sell, the entity considers whether market participants would still actively use the asset or benefit from it being locked up. If the answer to either question is yes, the entity then estimates the amount for which market participants would transact for that asset.

46 The staff understands that, under current practice (which we understand to be Situations 1 and 3), because a defensive intangible asset is not being used directly, it is difficult to allocate the asset to existing cash-generating units. As a result, it is often identified as a cash-generating unit by itself since it is excluded from the operations of the business. This is consistent with the notion that a cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. A defensive intangible asset in Situations 1 and 3 generates benefits on its own (that is the smallest group) by contributing to the value of the entity's existing assets.

47 In Situation 2, the defensive intangible asset is locked up and provides protection to the entity's existing assets. Because Situation 2 has not been addressed in practice under IFRS 3 (as issued in 2004), practice has not developed with regard to impairment testing. The staff thinks that entities would allocate the asset to the existing cash-generating units that are benefiting from the asset being locked up because it contributes indirectly to the entity's existing assets.

48 Although the staff thinks IAS 36 is clear on this point, we suggest amending IAS 36 to emphasise that a defensive intangible asset is not impaired immediately and that it might be identified as a cash-generating unit by itself when it is excluded from the operations of the business, or it might be allocated to an existing cash-generating unit if it contributes indirectly to the entity's existing assets.

What is the useful life of a defensive intangible asset?

49 Some wonder how to determine the useful life of a defensive intangible asset. Some argue that a defensive intangible asset should have an indefinite useful life when the

asset it is protecting has an indefinite useful life or because the protection the asset provides goes on indefinitely (even if the existing assets have finite useful lives).

50 Paragraph 88 of IAS 38 states that an entity shall assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life. An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

51 The staff thinks that, because of a lack of market exposure or because of competitive or other factors, it would be uncommon (EITF 08-7 uses the term 'rare') for a defensive intangible asset to have an indefinite life. For example, a trade name without an investment in advertising and promotion will lose its brand recognition, and as a result its value will decline over time.

52 Furthermore, although the fair value measurement is based on market participant assumptions, including investment in the asset, the useful life of an intangible asset is based on entity-specific assumptions and reflects the fact that the entity is not investing in the asset. This is because the useful life reflects the period over which the entity expects to generate economic benefits.

53 Current practice under IFRS 3 is to use a relatively short amortisation period for defensive intangible assets to reflect the expected decline in value resulting from a lack of investment in the asset.

54 It is worth considering what the appropriate amortisation period is. Paragraph 90 of IAS 38 lists some of the factors that should be considered when determining the useful life of an intangible asset, such as:

a the expected usage of the asset by the entity and whether the asset could be managed efficiently by another management team;

b typical product life cycles for the asset and public information on estimates of useful lives of similar assets that are used in a similar way;

c technical, technological, commercial or other types of obsolescence;

d the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

e expected actions by competitors or potential competitors;

f the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the entity's ability and intention to reach such a level;

g the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

h whether the useful life of the asset is dependent on the useful life of other assets of the entity.

55 When an entity acquires an asset it intends to lock up, the entity is 'using' the asset because it provides protection for its existing assets. The entity determines the useful life of the defensive intangible asset on the basis of its use within the business, which is to protect the value of the entity's competing assets. In other words, the entity would amortise the intangible asset for the period over which the entity generates indirect economic benefits from locking up the defensive intangible asset (including the factors listed in paragraph 54), regardless of the useful life and investment assumptions that formed the basis of the fair value measurement.

56 Although the staff thinks IAS 38 is clear on this point, we think it would be helpful if the Board amended IAS 38 to provide guidance about how to determine the useful life of a defensive intangible asset.

When does amortisation begin?

57 Paragraph 97 of IAS 38 states that the amortisation of intangible assets begins 'when the asset is *available for use*, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management' (emphasis added).

58 Therefore, the staff thinks defensive intangible assets would be amortised from the acquisition date. This is the point at which the asset is 'available for use'. The 'use' being that management benefits from holding the defensive intangible asset and

prevents others from using it, starting from the acquisition date. The staff thinks IAS 38 is clear on this point.

59 This applies equally to acquired research and development intangible assets. Normally, research and development intangible assets are considered to have an indefinite life until they are available for use, which typically is when they are completed. At this point the research and development intangible asset is amortised over its remaining useful life (using one of the amortisation methods described in paragraph 98 of IAS 38).

60 However, *defensive* research and development intangible assets, even though they are not yet completed and might not be, provide economic benefits at the acquisition date. That is, the entity is able to remove the potential for a competing product to enter the market, thereby indirectly benefitting the entity's existing research and development assets. In this way, they are being used the way management intended from the acquisition date (as a locked up asset). In other words, at the acquisition date the entity benefits from holding the asset and preventing others from using it. As a result, defensive research and development intangible assets would be amortised from that date. This point might not be clear in paragraph 97 of IAS 38.[5]

61 Consider the following example:

> Company A acquires an entity that has two products under development, Products X and Y. The development projects associated with these products include patents that would prevent others from pursuing development of these products. Company A plans to pursue the development of Product X but Product Y is similar to a product that Company A currently has under development, Product Z. Both Product Y and Z are in the early stages of development. However, Company A believes that if the development of Product Z is successful, it will be superior to Product Y. Therefore, Company A does not currently plan to pursue development of Product Y, but will hold Product Y as a backup to be pursued if the development of Product Z is not successful and Company A will not allow others to develop Product Y. If the development of Product Z is successful, Company A is unlikely to pursue the development of Product Y.

[5] Because the staff is unaware of entities recognising defensive research and development intangible assets (only trade names), we are unable to say whether this would be done in practice.

62 Under paragraph 97 of IAS 38, Company A would begin amortising the defensive intangible asset associated with Product Y over the period of expected benefit on the date of acquisition. If the development of Product Z is unsuccessful and Company A begins actively developing Product Y, the intangible asset associated with Product Y would no longer be considered a defensive intangible asset. Company A would cease amortising the defensive intangible asset until the project associated with Product Y is completed or abandoned.

63 Assume that Company A determines that Product Z will be completed in 3 years and the useful life of that product will be 15 years after its completion. *All else equal*, this would result in Product Y being amortised over 18 years: the 3 years up to completion (because Company A is benefiting now from Product Y being out of the marketplace) + the 15 years of useful life of Product Z after completion (because Product Y is still protecting the cash flows of Product Z during that time).[6]

64 The staff thinks that it is possible that entities might interpret paragraph 97 of IAS 38 to suggest that they should consider defensive research and development intangible assets to be indefinite lived until it is available for use and test them for impairment at least annually until the project to which it adds value is complete or abandoned. At that point, the entity would amortise the defensive research and development intangible asset over its expected life. This is the current practice for non-defensive research and development intangible assets.

65 As noted above, the staff thinks that it will be uncommon for a defensive asset to have an indefinite life because of the lack of market exposure or other factors. Therefore, the staff IAS 38 should be amended to clarify that defensive research and development intangible assets should be amortised from the date of acquisition because that is the point at which they are available for use.

Recent EITF decision about the subsequent accounting for defensive research and development intangible assets

[6] This is a simple example that assumes there are no other factors to consider in determining the useful life of the defensive research and development intangible asset, and this process might be different for other defensive intangible assets. It is likely that the useful life in this example will be in the range of 3 to 18 years, depending on patent lives, other products under development, market and economic dynamics, etc.

66 The staff notes that our recommendation is different from the subsequent accounting for defensive research and development intangible assets in EITF Issue No. 08-7 (EITF 08-7) *Accounting for Defensive Intangible Assets*, published in December 2008. EITF 08-7 is included in Appendix 2 to this Agenda Paper.

67 The EITF decided the following:

> …The Task Force reached a consensus that all research and development intangible assets should be excluded from the scope of this Issue and should instead be accounted for in accordance with paragraph 16 of [FASB Statement of Accounting Standards No. 142 *Goodwill and Other Intangible Assets* (SFAS 142); see below]. This Issue should apply to all other intangible assets acquired, including intangible assets acquired in a business combination, in situations in which the acquirer does not intend to actively use the asset but intends to hold the asset to prevent its competitors from obtaining access to the asset (defensive assets). The Task Force reached a consensus that this Issue should be applied prospectively for intangible assets acquired on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, in order to coincide with the effective date of Statement 141(R). Earlier application is not permitted.

68 The staff thinks the difference in subsequent accounting for defensive research and development intangible assets arises from the different requirements in IAS 38 and SFAS 142. Paragraph 16 of SFAS 142 states:

> If an intangible asset is determined to have an indefinite useful life, it shall not be amortized until its useful life is determined to be no longer indefinite. An entity shall evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life. If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the asset shall be tested for impairment in accordance with paragraph 17. That intangible asset shall then be amortized prospectively over its estimated remaining useful life and accounted for in the same manner as other intangible assets that are subject to amortization. **Intangible assets acquired in a business combination that are used in research and development activities (regardless of whether they have an alternative future use) shall be considered indefinite lived until the completion or abandonment of the associated research and development efforts.** During the period those assets are considered indefinite lived they shall not be amortized but shall be tested for impairment in accordance with paragraph 17. Once the research and

> development efforts are completed or abandoned, the entity shall determine the useful life of the assets based on the guidance in this Statement. Consistent with the guidance in paragraph 28 of Statement 144, intangible assets acquired in a business combination that have been temporarily idled shall not be accounted for as if abandoned. (emphasis added)

69 This is different from IAS 38, which states that the amortisation of intangible assets begins 'when the asset is **available for use**, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management' (IAS 38.97; emphasis added).

70 The staff thinks this is not something to address in the fair value measurement project, but, if at all, in a possible future project addressing the accounting for intangible assets.

Part 4: Disclosure

71 Users of financial statements might find it helpful if entities distinguished, by asset class, the intangible assets acquired in a business combination between those being actively used in the business and those being used defensively.

72 For example, Entity X in the example in paragraph 27 might disclose that it acquired trademarks with a fair value of CU100, of which CU10 relates to a trademark that Entity X will not use, but will lock-up for competitive reasons, although market participants would continue to use the asset actively in the business.

73 SFAS 157, SFAS 142, SFAS 141(R) and EITF 08-7 do not require disclosures about defensive intangible assets.

74 The staff recommends that IAS 38 be amended to require entities to disclose such information.

Staff recommendations and questions for the Board

75 The staff recommends that the Board:

a confirm its decision in IFRS 3 (revised in 2008) that defensive intangible assets should be recognised and measured at fair value in a business combination. The staff thinks the Board has determined that a defensive intangible asset meets the asset recognition criteria and should not reconsider this decision in the fair value measurement project. **Does the Board agree? If not, why not?**

b not provide explicit valuation guidance on measuring the fair value of defensive intangible assets. The staff thinks the measurement of defensive intangible assets has been developed by practice that has evolved under the current IFRS 3. Having said that, the staff plans to prepare educational materials for entities in emerging markets and will consider addressing the valuation of defensive intangible assets in those materials (the form and scope of which is yet to be determined). **Does the Board agree? If not, what form of valuation guidance do you think is necessary?**

c amend IAS 36 to address the impairment testing of defensive intangible assets. That is, emphasise that a defensive intangible asset is not impaired immediately and that it might be identified as a cash-generating unit by itself when it is excluded from the operations of the business, or it might be allocated to an existing cash-generating unit if it contributes indirectly to the entity's existing assets. **Does the Board agree? If not, why not?**

d amend IAS 38 to:

i to provide guidance about determining the useful life of a defensive intangible asset. **Does the Board agree? If not, why not?**

ii state that the amortisation period and useful life for defensive research and development intangible assets begins on the date of acquisition because that is the point at which they are available for use. This will avoid misinterpretation of paragraph 97, which might be read to suggest that defensive research and development intangible assets are indefinite lived until their completion date. **Does the Board agree? If not, why not?**

iii require entities to distinguish in their disclosures the intangible assets acquired in a business combination between those being actively used in the business and those being used defensively, by asset class. **Does the Board agree? If not, why not? Are there other disclosures about defensive intangible assets that should be required?**

Appendix 1: SFAS 157 Example 1—Asset Group

A7 The reporting entity, a strategic buyer, acquires a group of assets (Assets A, B, and C) in a business combination. Asset C is billing software developed by the acquired entity for its own use in conjunction with Assets A and B (related assets). The reporting entity measures the fair value of each of the assets individually, consistent with the specified unit of account for the assets. The reporting entity determines that each asset would provide maximum value to market participants principally through its use in combination with other assets as a group (highest and best use is in-use).

A8 In this instance, the market in which the reporting entity would sell the assets is the market in which it initially acquired the assets (that is, the "entry" and "exit" markets from the perspective of the reporting entity are the same). Market participant buyers with whom the reporting entity would transact in that market have characteristics that are generally representative of both financial buyers and strategic buyers and include those buyers that initially bid for the assets.[*] As discussed below, differences between the indicated fair values of the individual assets relate principally to the use of the assets by those market participants within different asset groups:

(a) *Strategic buyer asset group*. The reporting entity, a strategic buyer, determines that strategic buyers have related assets that would enhance the value of the group within which the assets would be used (market participant synergies). Those assets include a substitute asset for Asset C (the billing software), which would be used for only a limited transition period and could not be sold standalone at the end of that period. Because strategic buyers have substitute assets, Asset C would not be used for its full remaining economic life. The indicated fair values of Assets A, B, and C within the strategic buyer asset group (reflecting the synergies resulting from the use of the assets within that group) are CU360, CU260, and CU30, respectively. The indicated fair value of the assets as a group within the strategic buyer asset group is CU650.

(b) *Financial buyer asset group*. The reporting entity determines that financial buyers do not have related or substitute assets that would enhance the value of the group within which the assets would be used. Because financial buyers do not have substitute assets, Asset C (the billing software) would be used for its full remaining economic life. The indicated fair values of Assets A, B, and C within the financial buyer asset group are CU300, CU200, and CU100, respectively. The indicated fair value of the assets as a group within the financial buyer asset group is CU600.

A9 The fair values of Assets A, B, and C would be determined based on the use of the assets as a group within the strategic buyer group (CU360, CU260, and CU30). Although the use of the assets within the strategic buyer group does not maximise the fair value of each of the assets individually, it maximises the fair value of the assets as a group (CU650).

[*] While market participant buyers might be broadly classified as strategic and/or financial buyers, there often will be differences among the market participant buyers within each of those groups, reflecting, for example, different uses for an asset and different operating strategies.

Appendix 2: EITF Issue No. 08-7 Accounting for Defensive Intangible Assets

EITF ABSTRACTS

Issue No. 08-7

Title: Accounting for Defensive Intangible Assets

Dates Discussed: September 10, 2008; November 13, 2008

References: FASB Statement No. 2, Accounting for Research and Development Costs
FASB Statement No. 141, *Business Combinations*
FASB Statement No. 141 (revised 2007), *Business Combinations*
FASB Statement No. 142, *Goodwill and Other Intangible Assets*
FASB Statement No. 157, *Fair Value Measurements*

Objective

1. **The objective of this Issue is to clarify how to account for defensive intangible assets subsequent to initial measurement.**

All paragraphs in this Issue have equal authority. Paragraphs in bold set out the main principles.

Background

2. An intangible asset acquired in a business combination or an asset acquisition that an entity does not intend to actively use but does intend to prevent others from using, has been commonly referred to as a "defensive asset" or a "locked-up asset" because while the asset is not being actively used, it is likely contributing to an increase in the value of other assets owned by the entity.

3. Historically, when an entity acquired a business or group of assets, it typically allocated little or no value to the intangible assets that it did not intend to actively use, regardless of whether another acquirer might have continued to actively use them. However, after the effective date of Statement 141(R), an intangible asset must be recognized at fair value in accordance with Statement 157, regardless of how the entity intends to use that asset.

4. Upon the effective date of both Statement 141(R) and Statement 157, entities will generally assign a greater value to a defensive intangible asset than would have typically been assigned under Statement 141. As a result, questions have arisen in practice regarding how defensive intangible assets should be accounted for subsequent to their acquisition, including the estimated useful life that should be assigned to such assets.

Scope

5. **This Issue applies to acquired intangible assets in situations in which an entity does not intend to actively use the asset but intends to hold (lock up) the asset to prevent others from obtaining access to the asset (a defensive intangible asset), except for intangible assets that are used in research and development activities.**[1]

6. A defensive intangible asset could include an asset that the entity will never actively use, as well as an asset that will be used by the entity during a transition period when the intention of the entity is to discontinue the use of that asset.

7. The determination of whether an intangible asset is a defensive intangible asset is based on the intentions of the reporting entity and that determination may change as the reporting entity's intentions change (for example, an intangible asset that was accounted for as a defensive intangible asset on the date of acquisition will cease to be a defensive asset if the entity subsequently decides to actively use the asset). Exhibit 08-7A contains examples illustrating the determination of whether an acquired intangible asset is a defensive intangible asset.

8. This Issue does not address the identification of market participants, market participant assumptions, or valuation issues associated with defensive intangible assets.

Recognition

9. **A defensive intangible asset should be accounted for as a separate unit of accounting. It should not be included as part of the cost of an entity's existing intangible asset(s) because the defensive intangible asset is separately identifiable.**

Subsequent Measurement

10. **A defensive intangible asset shall be assigned a useful life in accordance with paragraph 11 of Statement 142.**

11. A defensive intangible asset shall be assigned a useful life that reflects the entity's consumption of the expected benefits related to that asset. The benefit a reporting entity receives from holding a defensive intangible asset is the direct and indirect cash flows resulting from the entity preventing others from realizing any value from the intangible asset (defensively or otherwise). An entity shall determine a defensive intangible asset's useful life, that is, the period over which an entity consumes the expected benefits of the asset, by estimating the period over which the defensive intangible asset will diminish in fair value. The period over which a defensive intangible asset diminishes in fair value is a proxy for the period over which the reporting entity expects a defensive intangible asset to contribute directly or indirectly to the future cash flows of the entity.

12. It would be rare for a defensive intangible asset to have an indefinite life because the fair value of the defensive intangible asset will generally diminish over time as a result of a lack of market exposure or as a result of competitive or other factors. Additionally, if an acquired intangible asset meets the definition of a defensive intangible asset, it cannot be considered immediately abandoned.

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[1] Intangible assets acquired in a business combination that are used in research and development activities (regardless of whether they have an alternative future use) are accounted for in accordance with paragraph 16 of Statement 142. Statement 2, paragraph 11(c), requires an entity to expense the cost of an intangible asset used in research and development activities acquired in a transaction that does not qualify as a business combination if the intangible asset has no alternative future use.

Transition

13. This Issue shall be effective for intangible assets acquired on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

The provisions of this Issue need not be applied to immaterial items.

Exhibit 08-7A

EXAMPLES OF DEFENSIVE INTANGIBLE ASSETS WITHIN THE SCOPE OF ISSUE 08-7

The following examples illustrate the determination of whether an intangible asset meets the definition of a defensive intangible asset and is within the scope of this Issue. The examples do not address all possible ways of determining whether an intangible asset meets the definition of a defensive intangible asset. The examples also do not address the determination of the useful life of intangible assets that are within the scope of this Issue.

Example 1

Company A, a consumer products manufacturer, acquires an entity that sells a product that competes with one of Company A's existing products. Company A plans to discontinue the sale of the competing product within the next six months, but will maintain the rights to the trade name, at minimal expected cost, to prevent a competitor from using the trade name. As a result, Company A's existing product w is expected to experience an increase in market share. Company A does not have any current plans to reintroduce the acquired trade name in the future.

Analysis: Because Company A does not intend to actively use the acquired trade name, but intends to hold the rights to the trade name to prevent others from using it, the trade name meets the definition of a defensive intangible asset.

Example 2

Company A acquires a group of assets, one of which is billing software developed by the selling entity for its own use. After a six month transition period, Company A plans to discontinue use of the internally developed billing software. In valuing the billing software in connection with the acquisition, Company A determines that a market participant would use the billing software, along with other assets in the asset group, for its full remaining economic life (that is, Company A does not intend to use the asset in a way that is at its highest and best use). Due to the specialized nature of the software, Company A does not believe the software could be sold to a third party without the other assets acquired.

Analysis: Although Company A does not intend to actively use the internally developed billing software after a six month transition period, Company A is not holding the internally developed software to prevent others from using it. Therefore, the internally developed software asset does not meet the definition of a defensive intangible asset.