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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **September 2008, London**
Project: **Customer-Related Intangible Assets (Agenda Paper 6A)**

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1. The IFRIC has 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.

Submission

2. The submission notes that IFRS 3R 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 separability criterion.

3. Customer-related 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 separability criterion. Consequently, determining whether a relationship is contractual is critical to identifying and measuring both separately recognised customer relationship intangible assets and goodwill.

4. The submission identifies two sources of confusion in practice regarding how the distinction between contractual and non-contractual customer relationships should be made:

   - IFRS 3R does not define what a contract is
   - IFRS 3R gives an example that suggest that what would be considered contractual under common law is considered non-contractual by the standard.

5. The full submission is included in Appendix A.

Staff Analysis

Background

6. IFRS 3 and IAS 38 included guidance on identifiable intangible assets and, in particular on customer-related intangible assets, and identified whether they were identifiable because they arose from contractual-legal-rights or because they were separable. This guidance was based on SFAS 141 *Business Combinations* and EITF 02-17 *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*.

7. The guidance in IFRS 3R does not differ significantly from that in IFRS 3. The only major change in this area as a result of the second phase of the Board's business combinations project was to remove the requirement for an intangible asset to be reliably measurable for it to be recognised separately from goodwill. In the staff's view this might be the reason this issue has been raised now.

8. However, because requirements substantially the same as those in IFRS 3R existed in IFRS 3 and identical requirements existed in US GAAP from 2002, staff thought it desirable to try to confirm the submission's view that divergence exists in practice and if so, its source.

Survey of IFRIC members

9. To identify current practice with respect to the identification of customer relationship intangibles, the staff asked the IFRIC members to provide information about experience in their own organisations. While admittedly unrepresentative, we believed that this would provide us with an early indication of whether an issue exists that requires interpretation or other action. The questions and summarised responses are set out in Appendix B.

Discussion

10. From the responses received it appears that the major area of potential divergence in practice is when transactions with customers result from short-term purchase order or retail sales rather than longer term contracts. Some seem to take the view that because all transactions such transactions must eventually have a contractual basis, non-contractual customer relationship assets are virtually non-existent. Others do identify such assets with greater or lesser degrees of frequency depending on the industry.

11. It also appears that valuation experts may be taking different views in this area which could be contributing to diversity.

12. The staff also agrees with the submission's point that the example in IFRS 3R.B34 (a) is potentially inconsistent. It is hard to argue that if an intangible asset is separable 'in combination with a *related contract*' the depositor relationship in this example is non-contractual.

Staff recommendation

13. The staff recommends that the IFRIC add this issue to its agenda.

14. In response to the survey, several IFRIC members indicated their view that sufficient confusion/diversity in practice existed to warrant the IFRIC's attention.

15. The staff is of the view that the area of difficulty is relatively narrow. However, differences of opinion could result in substantially different accounting outcomes. On the other hand, the staff does not necessarily believe that adding the issue to the agenda should result in an Interpretation – more analysis and consultation are necessary before we could reach that conclusion.

16. Given that IFRS 3R is the result of a joint project between the Board and the FASB, the staff is also concerned about the potential for any action by the IFRIC or the Board to create divergence with respect to a converged standard. Therefore, we have consulted with FASB to make them aware of the issue and a member of the EITF staff has been assigned to act as a liaison and monitor the issue should the IFRIC decide to add it to the agenda.

17. We are also aware that various appraisal/valuation profession organisations may be forming working groups to specifically consider these issues. We believe that it would be very useful for us to be aware of their deliberations to ensure that any guidance they produce is consistent with the Boards' intentions.

18. If the IFRIC decides to add the issue to the agenda, the staff proposes to present a more complete project proposal at the November meeting.

Question for the IFRIC

19. Does the IFRIC agree with the staff recommendation?

APPENDIX A

IFRIC POTENTIAL AGENDA ITEM REQUEST

Issue

IFRS 3R.10 requires that an acquirer must recognise, separately from goodwill, the identifiable assets of the acquiree.

IFRS 3R.B31 indicates that an intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion.

The intangible assets may include customer related intangible assets.

The illustrative examples in IFRS 3R IE23 give the following examples of customer related intangible assets:
a) Customer list (non-contractual);
b) Order backlog (contractual);
c) Customer contracts and the related customer relationships (contractual); and
d) Non-contractual customer relationships (non-contractual).

Contractual customer relationships are recognised separately from goodwill as an intangible asset while non-contractual relationships are separately recognised only if they are separable. Otherwise they form part of goodwill. The contractual/non-contractual distinction is crucial under IFRS as the legal environment in many countries where IFRS preparers are based make it impossible to sell groups of customers, thus the separability criterion is not met. It is therefore important to determine whether the relationship is contractual or not as non-contractual relationships will only be recognised if they are separable.

This raises two issues:

1. IFRS 3R distinguishes contractual from non-contractual customer relationships but does not define what a contract is.
2. IFRS 3R gives an example which suggests that what under common law is contractual is considered to be non-contractual by IFRS 3R (depositor relationships and related deposits).

1. IFRS 3R distinguishes contractual from non-contractual customer relationships but does not define a contract.

According to IFRS 3R IE28, “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”.

IFRS 3R IE31 defines a non-contractual customer relationship as one that does not arise from a contract. IFRS 3R IE28 provides as an example of non-contractual customer relationships those which “arise through means other than contracts, such as through regular contact by sales or service representatives”.

A customer relationship normally requires the existence of a customer with a history of prior transactions. Under most jurisdictions transactions are considered to be contractual under common law, even in the absence of a formal signed contract.

It is therefore difficult to understand what the IASB means by "non-contractual customer relationship" as the presumption is that under common law they are all contractual.

2. IFRS 3R gives an example which suggests that what under common law is contractual is considered to be non-contractual by IFRS 3R.

IFRS 3R.B34 provides guidance for an intangible asset that is not individually separable but is separable in combination with a related contract, identifiable asset or liability. One example given is the one of a depositor relationship: "market participants exchange deposit liabilities and related depositor relationship intangible assets in observable exchange transactions. Therefore, the acquirer should recognise the depositor relationship intangible asset separately from goodwill". This example suggests that the depositor relationship is considered by IFRS 3R to be non-contractual, as it would otherwise be recognised separately irrespective of the existence of a liability. However, a depositor relationship normally implies the existence of a contract at law, which guarantees the customer that future or existing deposits will be refunded.

This example, combined with the absence of a definition of a contract, introduces some confusion on how the distinction between contractual and non-contractual customer relationship should be made.

Current practice

Our experience is that different views exist in practice about the classification of customer relationships as either contractual or non-contractual. This has led to divergence in practice giving rise to different accounting treatments.

For example, under the law of many territories a retailer that offers goods for sale and a customer entering the premises and accepting the offer to buy those goods creates a contract at law.

One view (View A) is that such a transaction creates a contractual relationship between the customer and the entity despite the lack of a formal written contract. Adopting such an approach categorises more customer relationships as contractual. This view is consistent with the definition of a contract under IAS 32.13 ("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 at law. Contracts may take a variety of forms and need not be in writing").

Another view (View B) is that the standard setter did not intend contractual customer relationships to cover such a broad spectrum of commercial arrangements between entities and their customers. Entering into a contract requires more commitment from customers and implies the existence of a formal written contract for the purchase of goods or services. Also, under this view, a customer relationship where all of the conditions of the relationship were “imposed” by the service provider, for example where the provider has a monopolistic position, are considered to be non-contractual.

Reasons for the IFRIC to address the issue:

Guidance on the circumstances under which a non-contractual customer relationship arises is critical as the customer base is a significant asset in most acquisitions. The accounting treatment of customer relationships at acquisition date differs depending upon whether they are contractual or non-contractual.

The lack of clarity gives rise to significant different practices around the world as each view results in significantly different financial impact in the post acquisition period. For example, a contractual customer relationship may be amortised over a short period while a non-contractual customer relationship that is not separable will form part of goodwill.

We believe that clarifying the circumstances where a non-contractual relationship arises would eliminate the diversity in practice and would improve financial reporting.

APPENDIX B

SURVEY QUESTIONS AND SUMMARISED REPONSES

<u>Question 1</u> Are people having difficulty distinguishing customer relationships that are contractual from those that are not? This is an important factor in deciding whether the intangible needs to be separated.

1. On a number of transactions I have looked at, an issue has arisen with regard to the status of a 'term sheet/price list'. That is, a document that specifies how entities will transact with each other but by no means is it necessarily exclusive and it does not guarantee any revenues - typically the supplying entity is viewed as a 'preferred supplier'. The question has arisen as to whether such term sheets constitute a contract and therefore give rise to a contractual relationship for the purposes of IFRS 3.

   We have taken the view that such term sheets are not contracts and of themselves do not give rise to a contractual relationship. However, when these entities do transact, typically it is via a purchase/sales order which is a contract. Therefore, consistent with Example 3 in the Illustrative Examples to IFRS 3, to the extent that the customer is recurring, by virtue of doing business via contracts (i.e. POs) a contractual relationship exists and would need to be valued - said valuation being based on the expectation of future business with the customer.

   Other issues that have arisen include retail contracts in the utilities industry. For example, some utilities get retail customers to sign, say, 2 year contracts. However, some argue that the cost of breaking the contract is minimal (or zero by virtue of the regulator preventing/limiting entities from fining customers who wish to switch providers) and therefore they claim that revenue is not necessarily guaranteed and that there is no intangible. However, we have again taken the view consistent with the Examples in the Illustrative Examples to IFRS 3 that a contractual relationship does exist and that cancellation by the customer is ultimately a measurement rather than a recognition issue (i.e. the Examples to IFRS 3 emphasise that even 'cancellable' contracts can give rise to contractual relationships).
2. Contractual customer relationships appear relatively easy to identify in the form of "recurring type" business contracts such as maintenance agreements where we have a recurring revenue stream locked in over a period of time.

   To identify non-contractual relationships, we have typically looked at repeat "one-off type" business such as installation jobs with the same customer over a period of time. If there was a strong relationship of repeat business with a customer, we would potentially consider it a potential customer relationship that needs to be valued. To the extent this repeat business was more tending towards a single-source basis, we would assume that the relationship exists and needs to be valued. Alternatively, if the business is competitively bid, then it would be more tending towards not being based upon a customer relationship.

3. The definition of non-contractual relationship is unclear and an explicit definition would be highly appreciated. Usually there are no difficulties to distinguish customer relationships that are contractual from those that are not if the definition of non-contractual relationship is an existing relationship that may become a contractual relationship in the future.

4. Whilst some respondents did not believe it problematic to distinguish between contractual and non-contractual customer relationships, others argued that it is often difficult to identify a relationship to be separately valued that has no underlying contractual basis. The following layers of customer relationships have generally been identified:

   Order backlog: Always treated separately for purposes of determining the fair value. Generally there are no problems of identification.

   Binding long-term contracts: For example, telco, energy, cable networks providing contracts. Generally no problems of identification and generally combined with the related customer relationship, with the latter being the likelihood of contract extension.

   Related customer relationships: These are generally based on the guidance and examples provided in IFRS 3 if they are likely to have a high economic value. These usually consist of short term contracts (contract and fulfillment more or less at the same time), where no real order backlog exists. As contracts are signed on a regular basis, the whole value comes from the related customer relationship rather than from the existing contracts at the day of acquisition. Therefore it is a theoretical combination of contract and related customer relationships (to justify the existence of a contractual relationship). However, from an economic point of view it is nearly only related customer relationships.

   Non-contractual customer relationships: Having gone through the first few steps there is usually not much left that qualifies as a separate asset because the notion of a contractually-based customer relationship also includes situations when the entity has a practice of establishing contracts with its customers, regardless of whether a contract exists. Perhaps the most common example of a non-contractual customer relationship arises in the retail industry. As more retailers establish or expand customer loyalty programs and co-branded credit cards, they gain greater access to customer-specific information which facilitates the identification and valuation of the relationship. However, even under this scenario I might argue that the fact that a customer has a loyalty card means that he/she regularly purchases goods from me and hence there is a practice of establishing contracts and, accordingly, this is therefore a contractual relationship. This demonstrates I think the problems we have in identifying what exactly is a non contractual relationship. Is it a target customer for which there has been no contract in the past - maybe, but I'm not sure how much this would be worth.

5. Due to the broad definition applied to the contractual customer relationship (above), most identified customer relationship intangibles are being separated from goodwill.

However, differences in practice as to how to estimate the value of customer relationships continue to arise. The main reason for this is the difficulty in proving that a customer relationship is identifiable. At a minimum, we need to prove it by using records of customer orders etc. While this is possible for a company-to-company transaction, it is not possible for a company-to-consumer transaction.

When we consider investing in a company, we estimate that present regular customers will repeat their buying from that company. But this is not contractual and is based solely on the customer list. It is quite difficult to distinguish new customers from repeat customers.

Some appraisers do not estimate the value of repeat customers and therefore do not separate it from goodwill. However, other appraisers try to estimate the value of repeat customers to the extent possible.

It also depends on the attitude of the investing company. If the investing company has a strong intention to avoid non-amortizable goodwill, then it is possible to minimize goodwill as much as possible. However, if the investing company does not care about goodwill, most of the amount may go to goodwill. Therefore, I guess there is divergence in practice.

6. In recent business combinations in our group we have identified five main types of customer relationships. All of these customer relationships do result from an agreement with the customer and are therefore contractual. We have not identified customer relationships in the industry which are not based on some kind of contractual relationships. However, the customer relationships we identified do not all have the same level of continuity based on the nature of the agreement and the barriers to exit.

   Discussions with others in the industry indicate that generally there are not too many problems identifying customer relationships. In certain instances non-contractual relationships have been identified and because in the circumstances it was appropriate these were valued. Difficulties have however been identified in the valuation of non-contractual relationships and the estimation of attrition has caused some issues in practice.

<u>Question 2</u> In your experience are many identified customer relationship intangibles being included with goodwill on the basis that they are non-contractual and can't be separated?

1. I have not really seen any non-contractual relationships being separately recognised from goodwill - I have only ever seen contractual relationships being recognised - and even then arguments have been raised to try and avoid their recognition.
2. From our perspective, all customer relationships are generally valued separately from goodwill (contractual and non-contractual). In certain limited circumstances, it can be difficult to differentiate between the non-contractual customer relationship that an acquired entity may have versus the potential that customers may be making vendor selection based upon the skills and capabilities that are embodied in the workforce (individually or combined). A small amount is carved out of the customer relationship asset valuation for the "estimated cost" to replace the workforce and is not assigned separate value from goodwill.
3. In most cases customer relationships are separated from goodwill because they can be valued separately.
4. Generally this is not seen as a big issue because most customer relationships will arise from contracts. This will however to some extent depend on the industry (for example retail example).
5. We have not identified significant customer relationships in our industry which are not formed on the basis of some kind of a contract. Discussions with others have indicated that in most instances a value has been placed on the relationship. It seems that it is easier to identify and value these kinds of relationships for internet service providers than in other industries.

<u>Question 3</u> An overall customer relationship intangible that is recognised separately from goodwill may include various elements with different useful lives. Are those elements being distinguished and valued separately?

1. I have not seen components of a customer relationship asset being attributed different useful lives. Generally the asset is attributed one useful life which is based on a view regarding customer attrition. What I have seen however is different relationship assets being recognised for different business units within an acquired entity and different useful lives being attributed to the different customer groups in line with the attrition rates application to the particular business units.
2. For smaller transactions where we do not separately value different customer relationships, we generally use composite assumptions, as well as a composite useful life, and therefore amortize based on a uniform useful life.
   For larger transactions where we do value different customer relationships separately, we do assign unique amortizable lives. However, the

determination of those lives is a highly subjective process and dependent upon the interpretation of the local team's view on how long larger non-contractual customers might continue to place orders in the event no additional selling and marketing was conducted post-acquisition. Given some of the points regarding "skills and capabilities embodied in the workforce", it can be difficult to separate what is active marketing and selling which would be considered the costs to sustain a post-acquisition asset versus a customer's desire to purchase a "skillset" as it existed at acquisition.

3. Where contractual relationships are identified there are usually two elements identified - the order backlog/outstanding portion of the contract in place and the relationship which effectively represents the expected renewals. Where the outstanding portion of the contract is short (less than 6 months) it is often subsumed into the relationship asset. Occasionally there may also be a deferred revenue element.

4. Responses received to this question varied. If there are material underlying contracts, then some practice is to value these contracts and any related relationship separately and identify a specific amortisation period. However, in many instances in practice, other than for order backlogs, a single customer-related asset is valued which includes the contract and a related customer relationship. This results in a single intangible asset rather than two distinct assets with presumably different useful lives.

5. For customers with similar attributes, the customer relationship intangible asset is usually included as a single asset and amortized over an aggregate, estimated useful life of the customer pool; rather than amortizing individual customer relationship values.