



Project **Annual Improvement Project**

Topic **Amendment to IFRS 3 – Customer-related intangible assets**

Purpose of this paper

1. At its December 2008 meeting, the Board tentatively concurred with the IFRIC's recommendations to consider proposed amendments to IFRS 3 *Business Combinations* that clarify the guidance on non-contractual customer relationships acquired in a business combination. The Board also directed the staff to liaise with the FASB to prepare additional analysis for a future meeting. This paper summarises the additional analysis and the staff recommendation.

Staff recommendations

2. The staff recommends that the Board add this issue to the Annual Improvements project and amend IFRS 3 to:
 - (a) include in the standard those indicators that identify the existence of a customer relationship currently in paragraph IE28 of illustrative examples of IFRS 3 as the IFRIC recommended.
 - (b) relocate the depositor relationship example in paragraph B34(a) of the application guidance of IFRS 3 from the section that illustrates 'separable' intangibles to a more appropriate location in that guidance.Appendix B includes the proposed drafting for the amendment.
3. The staff also recommends that the Board defer to the post-implementation review of the revised standards one of the IFRIC's recommendations for this

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Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

issue. The IFRIC recommended that the Board consider removing the distinction between the treatments of ‘contractual’ and ‘non-contractual’ customer-related intangible assets in a business combination and focus on the nature of the relationship rather than how it is established. See Item 3 in Appendix C of Agenda Paper 13K.

Staff analysis

4. Agenda Paper 11G of the Board’s December 2008 meeting includes the background and an extensive staff analysis on this issue. Appendix A includes the relevant extract from the IASB Update of that meeting. The two IFRIC recommendations being considered by the Board are:
 - (a) **Proposal A** – remove the distinction between the treatments of ‘contractual’ and ‘non-contractual’ customer-related intangible assets in a business combination and focus on the nature of the relationship rather than how it is established; and
 - (b) **Proposal B** – review the indicators that identify the existence of a customer relationship in paragraph IE28 of the guidance on implementing IFRS 3 and include them in the standard (IASB only).
5. As the Board directed, the staff liaised with the FASB staff about those proposals to amend IFRS 3. The following paragraphs include the additional staff analysis on those proposals.

Proposal A – Remove the distinction between the treatments of ‘contractual’ and ‘non-contractual’ customer-related intangible assets in a business combination and focus on the nature of the relationship rather than how it is established

6. The FASB staff confirmed that the FASB had not received any questions on this issue. Even though similar confusion existed under SFAS 141, the US practice that developed after the definition of a customer relationship was clarified by EITF 02-17 is to recognise 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. The same definition exists in IFRS 3R. The guidance, however, is located in paragraph IE 28 of the Implementation Guidance, not in the standard.
8. The staff previously noted its agreement 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 still believes 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, the staff at both the FASB and the IASB agree that 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. Consequently, it is more appropriate to review this issue as a joint FASB/IASB project that is a part of either a post-implementation review or a broader-based review (if sooner) of the revised standards.

Recommendation and Question 1

For the reasons discussed in paragraphs 6-10, the staff recommends deferring to the post-implementation review of the revised standards the IFRIC's recommendation to remove the distinction between the treatments of 'contractual' and 'non-contractual' customer-related intangible assets in a business combination. Does the Board agree?

Proposal B – review the indicators that identify the existence of a customer relationship in paragraph IE28 of the guidance on implementing IFRS 3 and include them in the standard (IASB only).

11. As mentioned in paragraph 6, EITF 02-17 clarified the definition of a ‘customer relationship’ under US GAAP shortly after SFAS 141 became effective for business combinations after 1 July 1 2001.
12. That same definition is also carried forward by SFAS 141R in paragraph A41 in its Implementation Guidance. The staff notes that US GAAP does not distinguish between mandatory and non-mandatory guidance. However, the location of that same guidance in IFRSs is in paragraph IE28 in the Illustrative Examples of IFRS 3, which is a part of the non-mandatory guidance.
13. Given the confusion among IFRS constituents on this issue, the staff believes that moving the indicators that identify the existence of a customer relationship from paragraph IE28 to the mandatory guidance of IFRS would be a useful short-term solution.
14. In addition, many IFRS constituents noted that the example of a ‘depositor relationship’ in paragraph B34(a) of IFRS 3 contributes to the existing confusion in practice about distinguishing between contractual and non-contractual customer relationship intangible assets. That example is used to illustrate ‘separable’ intangibles. However, it implies that the depositor relationship would be a ‘non-contractual’ intangible when such relationship actually arises from existing depositors and, therefore, is established based on contracts.
15. The staff thinks that the Board should delete this example from the section that illustrates ‘separable intangibles’.
16. As noted previously, the staff was unable to identify another ‘separable’ customer relationship intangible asset that is truly ‘non-contractual’ (based on the staff analysis presented in Agenda Paper 11G at the December 2008 meeting). Once the Board reassesses the more fundamental issue that the IFRIC recommended in Proposal A, the staff does not think an example will be necessary.

17. The staff thinks that these amendment proposals are appropriate for inclusion in the upcoming *Improvements to IFRSs ED* to be published in August 2009.

Recommendation and Question 2

For the reasons discussed in paragraphs 11-13, the staff recommends that the Board amend IFRS 3 to move the indicators that identify the existence of a customer relationship from paragraph IE28 to the mandatory guidance in IFRS 3 as the IFRIC recommended. Does the Board agree? Proposed drafting is included in Appendix B.

Recommendation and Question 3

For the reasons discussed in paragraphs 14-16, the staff recommends that the Board amend IFRS 3 to delete a depositor relationship example from the section that illustrates 'separable intangibles'. Does the Board agree? Proposed drafting is included in Appendix B.

Recommendation and Question 4

Does the Board agree with the staff's recommendation to include the above proposed amendments to IFRS 3 in the upcoming Annual Improvements ED to be published in August 2009?

Appendix A

IASB Update (December 2008)

IFRS 3 *Business Combinations* – Customer-related intangible assets

The IFRIC received a request to provide guidance on a non-contractual customer relationship acquired in a business combination. At its meeting in November 2008 the IFRIC recommended that both the IASB and the FASB should:

- remove the distinction between the treatments of ‘contractual’ and ‘non-contractual’ customer-related intangible assets in a business combination and focus on the nature of the relationship rather than how it is established; and
- review the indicators that identify the existence of a customer relationship in paragraph IE28 of the guidance on implementing IFRS 3 and include them in the standard (IASB only).

The Board tentatively decided to consider a proposed amendment to IFRSs. The staff will liaise with the FASB to develop a project plan and prepare additional analysis for a future meeting.

Appendix B – Proposed draft amendment to IFRS 3

In Appendix B Application guidance, after paragraph 32, paragraphs B32A is added. Paragraph B34(a) is deleted. *Paragraphs B32 and B33 are not proposed for amendment but included for ease of reference.*

Recognising particular assets acquired and liabilities assumed (application of paragraphs 10-13)

Intangible assets

- B32 An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations. For example:
- (a)-(c) ...
- B32A 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. *[Previously paragraph IE 28 of IFRS 3]*
- B33 The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed,
- B34 An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset or liability. For example:
- (a) ~~— [Deleted] 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.~~
- (b) ~~— an acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. To transfer ownership of a trademark, ...~~

In the Illustrative Examples, paragraph IE28 is deleted. *Paragraphs IE25-IE27 and IE29-IE31 are not proposed for amendment but included for ease of reference.*

Identifiable intangible assets

Order or production backlog

- IE25 An order or production backlog arises from contracts such as purchase or sales orders. An order or production backlog acquired in a business combination meets the contractual-legal criterion even if the purchase or sales orders can be cancelled.

Customer contracts and the related customer relationships

- IE26 If an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships acquired in a business combination meet the contractual-legal criterion, even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquiree.
- IE27 A customer contract and the related customer relationship may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ.
- IE28 ~~[Deleted] 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.~~
- IE29 As noted in [paragraph IE25](#), an order or a production backlog arises from contracts such as purchase or sales orders and is therefore considered a contractual right. Consequently, if an entity has relationships with its customers through these types of contracts, the customer relationships also arise from contractual rights and therefore meet the contractual-legal criterion.

Examples

- IE30 The following examples illustrate the recognition of customer contract and customer relationship intangible assets acquired in a business combination.
- (a)-(d) ...

Non-contractual customer relationships

- IE31 A customer relationship acquired in a business combination that does not arise from a contract may nevertheless be identifiable because the relationship is separable. Exchange transactions for the same asset or a similar asset that indicate that other entities have sold or otherwise transferred a particular type of non-contractual customer relationship would provide evidence that the relationship is separable.

Amendments to the Basis for Conclusions

Paragraphs BC163A, BC167A and BC175A are added.

Applying the acquisition method

Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

Recognition

Distinguishing identifiable intangible assets from goodwill

Reasons for the contractual-legal criterion

BC163A In 2008 the IFRIC reported to the Board that diversity exists in practice regarding which customer relationships are considered to have a contractual basis and which are non-contractual. The Board noted that even though similar confusion existed under SFAS 141, the US practice that developed after the clarification issued by EITF 02-17 *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination* is to recognise 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 3. IFRS 3 carried forward that same definition as an illustrative example of indicators that identify the existence of a customer relationship, not as a mandatory part of the standard. Therefore, as part of the exposure draft of *Improvements to IFRSs* issued in August 2009, the Board decided to propose an amendment to IFRS 3 to include in the mandatory guidance those indicators that identify the existence of a customer relationship as the IFRIC recommended.

Reasons for the separability criterion

BC167A In 2008 the IFRIC reported to the Board that in practice the example of a depositor relationship being used to illustrate ‘separable intangibles’ was viewed as conflicting with a customer relationship that is established from prior contracts, therefore, meeting the contractual-legal criterion. When the Board considered the diversity that exists in practice regarding which customer relationships are considered to have a contractual basis and which are non-contractual, as described in paragraph BC163A, the Board agreed that a depositor relationship is a customer relationship that is established by a prior contract. It is an intangible that meets the contractual-legal criterion even though it can be transferred only with the underlying deposit contract and deposit liability. Therefore, as part of the exposure draft of *Improvements to IFRSs* issued in August 2009, the Board decided to propose an amendment to IFRS 3 to delete a depositor relationship example from the section that illustrates ‘separable intangibles’.

Illustrative list of intangible assets

BC175A Subsequent to the issuance of IFRS 3, as described in paragraph BC163A, the Board decided to propose an amendment to IFRS 3 to include in the mandatory guidance those indicators that identify the existence of a customer relationship as part of the exposure draft of *Improvements to IFRSs* issued in August 2009.