STAFF PAPER

November 2015

IASB Meeting

Project	**Goodwill and impairment project**		
Paper topic	Identification and measurement of intangible assets acquired in a business combination		
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Objective of this paper

1. The purpose of this agenda paper is to help IASB members:

   (a) develop their views about how to address the concerns raised about identifying and measuring intangible assets acquired in a business combination following the joint meeting with the US Financial Accounting Standards Board (FASB) in September 2015; and

   (b) decide whether they need additional information before developing their views in (a).

Structure of this paper

2. This paper includes the following sections:

   (a) Introduction to this agenda paper

   (b) Overview of feedback during the Post-implementation Review (PIR) of IFRS 3 *Business Combinations*

   (c) Options being considered by the FASB

   (d) Staff analysis

      (i) Overall objective of looking at identifying and measuring intangible assets in a business combination

(ii) Approach 1: No change to existing requirements

(iii) Approach 2: Subsume some identifiable intangible assets in goodwill

(iv) Approach 3: Remove assumption that acquirer can always reliably measure the fair value of identifiable intangibles acquired in a business combination

(v) Approach 4: Allow further grouping of intangible assets

(e) Guidance on customer relationships

(f) Addressing users concerns about the current information provided

(g) Staff recommendations and questions for the IASB

(h) The staff have provided the following four appendices for IASB member's reference when reading this agenda paper (these are provided in a separate agenda paper—see Agenda Paper 18C):

(i) Appendix A: Relevant extracts from comment letter analysis on the Post-implementation Review (PIR) of IFRS 3 *Business Combinations*

(ii) Appendix B: Summary of FASB meetings on their related project on accounting for identifiable intangible assets in a business combination

(iii) Appendix C: 2009 IFRIC agenda decision on customer-related intangible assets

(iv) Appendix D: Extracts from Basis for Conclusions accompanying IFRS 3(2004) and (2008)

Introduction to this agenda paper

3. The IASB's report and feedback statement on the PIR of IFRS 3 provided the following possible next steps to address identification and measurement of intangible assets:

Area of focus	**Assessed significance**	**Possible next steps**

Area of focus	Assessed significance	Possible next steps
Identification and fair value measurement of intangible assets such as customer relationships and brand names.	Medium/high	Research will be undertaken. We could consider whether particular intangible assets (for example, customer relationships) should be subsumed into goodwill. We could also consider what additional guidance could be given to assist in the identification of customer relationship intangibles and their associated measurement.

4. In this agenda paper the staff have provided their analysis on identification and measurement of intangible assets based on examining responses to the PIR, user outreach performed by the staff during the PIR, the work of the US Financial Accounting Standards Board (FASB) in their related project, and the IASB's reasoning for its current requirements and the history behind the development of those requirements.

5. At this meeting, the staff is only asking IASB members to have an initial discussion on the different approaches in this paper, rather than making decisions, for the following reasons:

   (a) Constituents of both the IASB and the FASB have expressed a desire for the Board's standards to remain converged where possible. The FASB has an active project on its agenda for public business entities and not-for-profit entities with the objective to evaluate whether certain intangible assets should be subsumed into goodwill for these entities. The staff think that the IASB should work with the FASB to avoid divergence and benefit from each other's work. Hence, the staff recommend decisions about potential amendments to IFRS 3 are best taken jointly with the FASB. Nevertheless because the FASB has already had its own discussion and discussed its leanings on this topic, the staff think the IASB should have its own discussions before continuing discussions with the FASB.

   (b) The staff think that the views of IASB members on identifying and measuring intangible assets in a business combination may affect their views on accounting for goodwill and impairment (and vice versa). For example, if IASB members support subsuming additional intangible assets in goodwill, this may influence their views on whether goodwill should be amortised and/or whether simplifications to the impairment requirements should be considered for goodwill. At the October 2015 IASB meeting, some IASB members said that before developing preliminary views on the staff proposals on accounting for goodwill and impairment, they would like additional information about the needs of investors (see Agenda Paper 18B for this meeting). Consequently before the IASB can decide how to address identification of intangible assets in a business combination, it will need to consider feedback from the user outreach and continue its discussions from the October 2015 meeting on goodwill and impairment.

(c) Once IASB members have discussed their preliminary views on goodwill, other intangible assets and impairment, the staff may need to provide further analysis on the interaction of those views before the IASB can make any decisions on possible changes.

Summary of feedback in the PIR (more detail in Appendix A)

6. The PIR identified concerns that some intangible assets are costly (because of the need to use valuation specialists), complex and time-consuming to measure at fair value. The PIR also identified that some users of financial statements say that the valuations of some intangible assets are subjective and do not provide useful information. Customer relationship intangibles were the most frequently cited examples by preparers, users and other parties. Brands were also commonly cited. Consequently some participants think the benefit of the information provided to users about these intangibles does not justify the costs of separately recognising them. Nevertheless, other users support recognising these intangible assets separately because it provides an insight on why an acquisition was made and about the primary assets/value drivers of the aquiree.

7. Participants also asserted that the following other intangible assets are challenging to measure (and also in some cases identify):

(a) non-contractual intangible assets.

(b) intangible assets that are not capable of being sold or licensed separately.

(c) intangible assets for which there is no active market.

(d) intangible assets in the early stage of development.

8. The main challenges identified during the PIR in measuring intangible assets were:

(a) the assumptions used in valuation models are difficult to determine and are subjective. Valuation models are sometimes sensitive to small changes in those assumptions.

(b) there are various valuation methods and there is diversity on when/how they are used.

(c) determining the useful lives of some intangible assets is subjective.

(d) where there are multiple intangible assets judgement is needed not only to value them individually but also to determine relationships. For example customer relationships are often incorporated in valuation methods applied to brands to which they relate, which could result in double counting.

Options being concerned by the FASB

9. At the September 2015 IASB/FASB meeting the FASB staff presented a paper that provided a summary of their outreach and work to date on accounting for identifiable intangible assets in a business combination for public business entities and not-for-profit entities (IASB Agenda Paper 13D/FASB Memo No 2 for that meeting). A summary of the FASB meetings where this project has so far been discussed has been included in Appendix B of this agenda paper for reference.

10. IASB Agenda Paper 13D noted that the FASB has discussed the following three primary views of how identifiable intangible assets acquired in a business combination could be accounted for (more detail in their paper):

(a) View A—All intangibles subsumed into goodwill, ie do not recognise any intangible assets in a business combination separately from goodwill.

(b) View B—Only intangibles capable of being sold or licensed independently from other assets of the business recognised separately, ie those that are capable of generating cash flows separate and distinct from a business. Four sub views:

(i) View B1—Intangible assets only would be separately recognized if they were capable of being sold or licensed independently from other assets of a business.

(ii) View B2 (PCC alternative)—Limited to noncompetition agreements (NCA) and customer-related intangibles (CRI). NCAs would not be separately recognised and CRIs only would be recognised if they are capable of being sold or licensed independently from other assets of a business.

(iii) View B3—Similar to View B2, but change limited to CRIs.

(iv) View B4—Narrower definition of contractual CRIs. This alternative consists of narrowing the guidance on when a CRI meets the contractual/legal criterion for recognition to exclude ongoing customer relationships associated with purchase-order-based or at-will customers.

(c) View C—No change to GAAP.

A key element of Views A and B is required disclosure of the nature (but not fair value) of identifiable, but not separately recognised, intangible assets.

11. In 2014 the PCC reached a consensus that View B2 should be provided as an option for private entities. However if private entities elect the option, they are also required to apply the PCC option for subsequent accounting for goodwill (including amortisation of goodwill over ten years or less[1]). The Private Company Council (PCC) determined that View A was not a viable alternative for private entities.

12. The FASB has not made a decision about which view or views it prefers for public business entities. However, View A was dropped from the views being considered at the October 2015 FASB meeting. Also, based on the discussion at the October 2015 FASB meeting, the staff think that the FASB is more focussed on View B2/B3 and View C (ie is more focused on either subsuming CRIs and noncompetition agreements, subsuming just CRIs, or leaving the current requirements unchanged for

[1] PCC alternative for goodwill. Amortise over 10 years or less if another useful life is more appropriate. Goodwill tested for impairment at the entity or the reporting unit level. Tested only when a triggering event occurs. Impairment loss measured as difference between carrying value and fair value of entity/reporting unit.

public business entities). The FASB has also noted that it is open to working with the IASB on this issue.

History of IFRS requirements for intangible assets in a business combination

Pre 2004

13. IAS 22 *Business Combinations* required an acquirer to recognise any identifiable asset of the acquiree separately from goodwill if it was probable that that any associated future economic benefits would flow to the acquirer (probability recognition criterion) and the asset could be measured reliably (reliability of measurement criterion). At the time IAS 38 *Intangible Assets* clarified that an intangible asset must be identifiable to distinguish it from goodwill. IAS 38 did not define 'identifiability', but stated that an intangible asset could be distinguished from goodwill if it was separable, though separability was not a necessary condition for identifiability. Consequently, pre IFRS 3(2004), an intangible asset had to be recognised separately from goodwill if it was identifiable, reliably measurable and it was probable that any associated future economic benefits would flow to the acquirer.[2]

Changes in 2004

14. On issue of IFRS 3(2004), the requirements were changed to state:

    (a) an intangible asset meets the identifiability criterion only if it:

        (i) is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or

        (ii) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

    (b) the probability recognition criterion is always considered to be satisfied for intangible assets in a business combination.

[2] Taken from paragraph BC88 of the Basis for Conclusions accompanying IFRS 3(2004).

(c) The fair value of an intangible asset acquired in a business combination can normally be measured with sufficient reliability to be recognised separately from goodwill (including a rebuttable presumption that fair value can be measured reliably if the intangible has a finite life).

(d) that the only circumstances when it might not be possible to measure reliably the fair value of an intangible asset acquired in a business combination is when it arises from legal or other contractual rights and it either:

(i) is not separable; or

(ii) is separable but there is no history or evidence of exchange transactions for the same or similar assets and otherwise estimating fair value would be dependent on variables whose effect is not measurable.

Changes in 2008

15. IAS 38 was amended to state that if an asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset. IAS 38 also clarified that separability does not depend on management’s intent. Consequently, under the current requirements an acquirer must recognise, separately from goodwill, all identifiable intangible assets acquired in a business combination at their acquisition-date fair values.

Staff analysis

What approaches should we consider

16. The staff think there are four approaches to consider:

(a) Approach 1—No change to existing requirements, but consider clarifying the requirements in IFRS 3/IAS 38 for customer relationships and possibly developing other guidance/education material

(b) Approach 2—Subsume some identifiable intangible assets in goodwill for cost-benefit reasons

(c) Approach 3— Remove statement that acquirer can always reliably measure the fair value of identifiable intangibles acquired in a business combination (ie reverse change made in 2008)

(d) Approach 4—Allow further grouping of intangible assets, ie relax the requirement for when a group of complementary intangible assets can be recognised and measured as a single asset (currently only permitted if they have similar useful lives)

17. The staff have not considered an approach whereby all intangibles should be subsumed in goodwill. Intangible assets are becoming increasingly important in the economy. The staff think that in general separate recognition of intangible assets provides better information to the users of financial statements than subsuming them in goodwill. Concerns have been identified about costs and benefits of separately recognising some, but not all, intangible assets. Consequently the staff do not think there is any basis for the IASB to consider including all intangibles in goodwill.

Overall objective of looking at identification and measurement of intangibles

18. The staff think the overall objective of looking at identification and fair value measurement of intangibles is to determine whether:

(a) subsuming any identifiable intangible assets acquired in a business combination in goodwill is supported by cost benefit reasons.

(b) if we identify any intangible assets in (a), whether guidance or education material would help mitigate cost benefit concerns rather than change the requirements.

19. The staff think there needs to be a strong argument to support making further significant changes to IFRS 3. Since 2004 the IASB has amended IAS 38 twice, each time requiring more intangible assets to be identified separately from goodwill (see paragraphs 13-15).

Approach 1: No change to existing requirements

Description

20. No change to existing requirements (and hence no change to the composition of goodwill), but consider clarifying the requirements in IFRS 3/IAS 38 for customer relationship intangibles and possibly developing other guidance/education material

*A*dvantages of not changing the existing requirements

21. The staff have identified the following as the key arguments for, and advantages of, not subsuming any identifiable intangible assets in goodwill (or at least being selective if we do consider subsuming additional intangible assets in goodwill):

(a) When the IASB amended IFRS 3 in 2008 it concluded separate recognition of intangible assets, on the basis of an estimate of fair value, rather than subsuming them in goodwill, provides better information to the users of financial statements even if a significant degree of judgement is required to estimate fair value (see paragraph BC174 of the Basis for Conclusions accompanying IFRS 3(2008)).

(b) Intangible assets are becoming increasingly important in the economy. Subsuming additional intangible assets in goodwill will increase the amount of goodwill recognised. This is likely to further increase the concerns we heard during the PIR about overstatement of goodwill. Consequently this will increase pressure to make the impairment test of goodwill more stringent. It will also increase pressure to reconsider an amortisation approach for goodwill. The IASB has consistently received feedback that amortisation of goodwill over an arbitrary period does not provide decision useful information for investors.

(c) If goodwill included dissimilar intangible assets, with different useful lives, different risks and different cash flows it would not provide a faithful representation of the assets acquired in the business combination. Including finite-life intangible assets in goodwill that is not amortised would further increase this concern.

(d) Separation of intangibles with different characteristics facilitates better analysis and enables better accounting for subsequent consumption and sale of those intangibles. For example, if an intangible asset subsumed in goodwill is sold, an entity's profit would not include the appropriate carrying amount for the calculation of the gain/loss on disposal of the asset. This would overstate the profit on sale and indicate goodwill is overstated. Also whilst some investors say that they do not find the fair value information about certain intangible assets useful, some of these users are still interested in any impairment of those intangibles. Such information could be lost if intangibles are included in goodwill.

(e) Some users support the current practice, because it provides an insight on why a company purchased another company and it helps in understanding the components of the acquired business, including its primary assets (ie the value-drivers). It also permits comparison between different accounting policies that management choose to make (for example, one entity may amortise customer lists over 10 years, whereas another entity may decide to amortise them over 20 years).

(f) Users are generally interested in information about intangible assets that are significant to the business (ie key value-drivers), even if some do not use information about other intangible assets. The key value drivers will vary depending on the type of entity and the industry it operates in. Intangible assets are often significant in industries that are heavily-driven by intangibles such as pharmaceutical and technology industries. If any entity subsumes any significant identifiable intangible assets in goodwill, information about the key underlying drivers of value may be lost. It is difficult to identify which intangible assets are significant across all entities and all industries and consequently which intangibles could be included in goodwill without significant loss of information.

(g) Some think an acquirer should identify and consider the fair value of all significant intangible assets when determining a reasonable acquisition price. They think the current requirements encourage acquirers to better analyse what they are buying.

(h) Some preparers note there are similar complexities in measuring the fair value of other assets in a business combination, for example inventories, plant and equipment. Consequently although subsuming some intangible assets in goodwill may reduce the cost for some entities, it may not have a significant impact on the overall cost and complexity of accounting for an acquisition. Furthermore some note that the costs incurred in valuing intangible assets separately in a business combination is a one-time cost, not an ongoing cost.

(i) There are often interrelations between intangible assets meaning it would be difficult to determine the fair value of one without determining the fair value of the other. Consequently allowing some intangible assets to be subsumed in goodwill may not reduce the overall cost of the valuation exercise.

(j) Some preparers say that some intangible assets are not separable from the cash flows of the business as a whole. However, one could argue that all assets of a business are interrelated (ie they form an integrated set of activities). This interrelationship is generally considered to be a component of goodwill (ie the synergies realised from using the assets together). This does not mean that the assets are not separable from goodwill. Taken to the extreme, one could argue that a business would not exist without any of its intangible assets, such as the customer, brand names, technology etc. In such a scenario no intangible assets would be recognised separately from goodwill.

Disadvantages of not changing the existing requirements

22. The staff have identified the following as the key arguments for, and advantages of, subsuming additional intangible assets in goodwill:

(a) Many preparers find fair value measurement of some intangible assets difficult and time consuming, and often need to use independent valuation specialists which makes the exercise costly (paragraph 8 lists the main challenges identified).

(b) Subsuming additional intangible assets in goodwill would be consistent with the accounting treatment for:

(i) intangible assets acquired in a business combination that are not recognised separately, for example an assembled workforce. Some think measurement of customer relationships and employee relationships involve similar considerations and should be treated the same way.

(ii) identical intangible assets that are generated internally. Some think that having a different accounting treatment for similar items depending on whether they are purchased or internally generated impairs comparability.

(c) Some preparers view the purchase price allocation as a pure accounting exercise because they do not consider some of these intangible assets when assessing the transaction and agreeing the purchase price.

(d) Some users say they only find fair value information about intangible assets useful if it can be determined reliably. Some users say they disregard the fair values of some intangibles, for example because the assumptions used in the valuations are too subjective and there is diversity in the valuation methods used/valuations attained for similar intangible assets. Many of these users think a qualitative description of those intangibles may be sufficient. Some are concerned that where valuations of intangibles are subjective, they are open to arbitrage opportunities during a business combination.

(e) Some users say that separate information about the intangible assets is only useful for a very short period of time, ie in giving them an understanding of what has been purchased at the date of acquisition. In subsequent periods the carrying value of the intangibles is not useful to them.

(f) Many users have concerns about separately identifying intangibles because of the effect of their amortisation on profits, rather than the fact they are recognised separately from goodwill. This is because they have concerns that amortising intangible assets that are considered to be continually replaced by the entity (eg brands and customer-related intangibles) results in double counting of expenses. This is because an entity will expense both amortisation and the expense incurred to grow new intangible assets or maintain existing ones, for example sales and marketing expenses. For this reason amortisation on these acquired intangibles (sometimes referred to as purchase price allocation (PPA) amortisation) is sometimes added back by preparers and users to derive an underlying earnings number.

(g) Some view recognising a large number of finite life intangibles separately from goodwill as a back door to goodwill amortisation. However, some think that amortisation of goodwill should be reintroduced, to reduce concerns about subsuming some intangible assets in goodwill.

Staff view

23. As noted in paragraph 19, the staff think there needs to be a strong argument for the IASB to reconsider the existing requirements. When the IASB amended IFRS 3 in 2008 it concluded that separate recognition of intangible assets on the basis of an estimate of fair value provides better information than subsuming them in goodwill. Intangible assets are becoming increasingly more important in the economy and constitute an increasing proportion of the assets of many entities. Consequently information about them is likely to become more important going forward.

24. Subsuming additional intangible assets in goodwill will increase the amount of goodwill recognised. This could heighten concerns we heard during the PIR about overstatement of goodwill and give rise to pressure to make the goodwill impairment test more stringent, rather than consider ways to simplify or reduce costs associated with it.

25. Subsuming finite life intangible assets in goodwill is also likely to create further pressure for the IASB to reintroduce an amortisation approach for goodwill. The IASB has consistently received feedback that amortisation of goodwill over an arbitrary period does not provide decision useful information for investors. In addition when developing the current requirements for goodwill, the IASB observed that the useful life of acquired goodwill and the pattern in which it diminishes are generally not possible to predict with a satisfactory level of reliability (paragraph BC131E of IAS 36). The staff think that the more different intangible assets subsumed in goodwill (with different useful lives, risks and cash flows), the more difficult it would be to determine an appropriate amortisation method and period for goodwill. The staff note that if private companies in the US elect the PCC option to subsume additional intangible assets in goodwill (View B2 in paragraph 10), those

entities must also elect the PCC alternative for goodwill (which requires amortisation).

26. For the reasons in paragraphs 21 and 23-25 the staff do not support subsuming any identifiable intangible assets in goodwill.

The need for guidance

27. Nevertheless, the staff suggest that the IASB should clarify the guidance in IFRS 3(2008) and the illustrative examples accompanying IFRS 3(2008) to address one of the main concerns about the requirements for customer relationships (see paragraphs 52-60 for more details). The staff think this should be done together with the FASB to avoid divergence.

28. The IASB could also consider whether helpful guidance or education material could be developed to address other issues. For example, in their comment letter on the Request for Information issued as part of the PIR the European Securities and Markets Authority (ESMA) noted that sometimes the subsequent accounting for intangible assets is not consistent with assumptions used to determine their fair value at the acquisition date. An example given was in the case of customer-related intangibles, the assumed churn-rate used in the fair value measurement to reflect the decreasing benefits from the acquired customer base is sometimes ignored in subsequent accounting (instead of a declining balance amortisation method, a straight-line method is applied). The staff think this type of issue could be addressed by guidance on determining an appropriate amortisation period and method.

29. The staff think the IASB should focus only on developing guidance to help preparers understand the requirements in IFRS 3/IAS 38, and also considering whether the disclosure requirements in IFRS 3 are sufficient to help users understand the assumptions used in the valuation models and the valuation models used (disclosures are considered later in this paper). The staff note that there is already much publicly available guidance on valuing intangible assets. Consequently, the staff do not think it would be a good use of the IASB's resources to develop additional valuation guidance. In their comment letter on the Request for Information issued as part of the PIR, Duff & Phelps asserted that the primary challenges related to separate recognition of intangible assets arise from accounting determinations rather than

valuation issues. They further assert that methodologies for valuing intangible assets have been, for the most part, fairly well established for a considerable amount of time.

Approach 2: Subsume some identifiable intangible assets in goodwill

Description

30. The IASB could consider whether any of the following identifiable intangible assets should be subsumed in goodwill for cost-benefit reasons:

    (a) The main intangibles for which we have received feedback that separate measurement is complex and costly (and that some users do not find useful):

        (i) Some customer-related intangibles, in particular customer relationships

        (ii) Brand names

        (iii) Non-contractual intangible assets

        (iv) Intangible assets that are not capable of being sold or licensed separately

        (v) Intangible assets for which there is no active market

        (vi) Intangible assets in the 'early stage' of development

    (b) Indefinite life intangibles that are difficult to value on an individual basis (this would not increase pressure to amortise goodwill)

    (c) Those being considered by the FASB:

        (i) noncompetition agreements (NCA)

        (ii) customer-related intangibles that are not capable of being sold or licensed independently.

General advantages and disadvantages of subsuming some identifiable intangible assets in goodwill

31. The general advantages and disadvantages of subsuming additional intangible assets in goodwill are listed in paragraphs 21 and 22.

Staff view

32. In approach 1 the staff provided their reasoning for why we do not support subsuming additional intangible assets in goodwill. Nevertheless if IASB members would like to pursue any of the approaches in paragraph 30 the staff would suggest the following:

(a) We should be extremely selective in which intangible assets we consider for the reasons given in paragraphs 21 and 23-25.

(b) We should consider if guidance or education material would help to mitigate some of the concerns before changing the requirements (as suggested for customer relationships in paragraphs 52-60).

(c) Based on the feedback received during the PIR, the staff think that customer relationships appear to be the most challenging intangible assets to measure separately from goodwill. There is also evidence from our outreach during the PIR that many users do not find information about these intangible assets as useful as other intangible assets. There are some concerns about brand names and the difficulties of measuring brands and customer relationships separately from each other.

33. The FASB are considering whether some customer-related intangibles should be subsumed in goodwill. Consequently, even though the staff prefer approach 1, the staff think the IASB should discuss the merits of including some customer related intangibles in goodwill with the FASB to prevent divergence between the Board's converged Standards. Nevertheless the staff note that customer related intangibles often have short lives and so subsuming them in goodwill may increase pressure for goodwill to be amortised. The staff further notes that this discussion should be linked to discussions about developing guidance on customer relationships and other customer-related intangibles which may mitigate some of the concerns (see paragraph 52-60).

34. Nevertheless, the staff are unsure whether subsuming some customer related intangibles in goodwill would necessarily have a significant enough reduction in the cost and complexity of the fair value allocation exercise to warrant the change. Furthermore, there are often interrelations between customer related intangibles and other assets. For example a customer relationship often arises as a result of brand

loyalty, and we have received some feedback during the PIR that customer relationships are considered in determining the fair value of brands and are difficult to measure separately. Consequently the staff think that it may be difficult to determine the fair value of some brands without also determining the fair value of related customer relationships to avoid including their fair value in the value of the brand. In such cases subsuming customer related intangibles within goodwill, without also subsuming brands, may not reduce the overall cost of the valuation exercise.

35. If we also consider subsuming brands into goodwill, this may help to address the issue in paragraph 34. However, it would increase concerns about the appropriate accounting for goodwill, particularly as some brands have considerable value. The staff notes that the FASB are not considering subsuming brands in goodwill as part of their project (see paragraph 10). Consequently if the IASB consider brands this could result in divergence between the Board's converged Standards.

36. The FASB are also considering noncompetition agreements. However, the staff notes that only one respondent to the PIR specifically referred to noncompetition agreements. Consequently, based on our feedback the staff do not think there is a strong basis for subsuming noncompetition agreements in goodwill.

Approach 3—Only separately recognise those intangibles for which fair value can be measured reliably

Description

37. IFRS 3(2004) only required an acquirer to separately recognise identifiable intangible assets of an acquiree that could be measured reliably. Some think that removing this criterion in IFRS 3(2008) has resulted in increased concerns that some intangible assets, such as customer relationships and brands, are complex and subjective to measure and do not provide useful information.

Basis for 2004 reliability of measurement criterion

38. Paragraphs BC97-BC101 of the Basis for Conclusions accompanying IFRS 3(2004) explain the IASB's reasoning for including the reliability of measurement criterion in IFRS 3(2004). In the December 2012 Exposure Draft (ED 3 *Business Combinations*) the

IASB had concluded that except for an assembled workforce, sufficient information could reasonably be expected to exist to measure reliably the fair value of an asset that has an underlying contractual or legal basis or is capable of being separated from the entity. However respondents to ED 3 generally disagreed arguing that:

(a) it might not always be possible to measure reliably the fair value of an asset that has an underlying contractual or legal basis or is capable of being separated from the entity; and

(b) a similar presumption does not exist in IFRS for identifiable tangible assets acquired in a business combination.

39. After considering respondents' comments and the experience of field visit and round-table participants during the comment period for ED 3, the Board concluded that, in the following instances, there might not be sufficient information to measure reliably the fair value of an intangible asset separately from goodwill:

(a) those that arose from legal or other contractual rights and are not separable (ie could be transferred only as part of the sale of a business as a whole).

(b) those that arose from legal or other contractual rights and are separable, but there is no history or evidence of exchange transactions for similar assets, and otherwise estimating fair value would be dependent on variables whose effect is not measurable.

40. Nevertheless, even though IFRS 3(2004) included a reliability of measurement criterion, the IASB noted that it remained of the view that the usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill, particularly given goodwill is not amortised. The IASB also remained concerned that the reliability of measurement criterion might be inappropriately used. The Board observed when developing ED 3 that although intangible assets constitute an increasing proportion of the assets of many entities, those acquired in business combinations were often included in goodwill, despite the requirements in IAS 22 that they should be recognised separately.

Staff view

41. The general advantages and disadvantages of subsuming additional intangible assets in goodwill are listed in paragraphs 21 and 22.

42. In approach 1 above the staff has provided their reasoning for why we do not think we should subsume additional intangible assets in goodwill. In paragraph 32, the staff also suggested that if IASB members wish to consider subsuming some identifiable assets in goodwill then we should be selective to avoid subsuming too many for the reasons given in paragraphs 21 and 23-25.

43. The staff have concerns, like the IASB highlighted in paragraph BC101 accompanying IFRS 3(2004), that a reliability of measurement criterion might be too freely applied, resulting in many additional intangible assets being subsumed in goodwill. Furthermore, comment letters from respondents in the valuation industry during development of IFRS 3(2008) told us that all identifiable intangible assets can be measured reliably at fair value.[3]

44. The recognition criteria in the existing *Conceptual Framework* state that an entity recognises an asset or a liability if it has a cost or value that can be measured with reliability. However, in its Exposure Draft proposing a revised *Conceptual Framework for Financial Reporting* the IASB proposes not to retain reliability of measurement as a recognition criterion. Instead it proposes that measurement uncertainty is discussed as an indicator that recognition may not provide relevant information. When the IASB amended IFRS 3 in 2008 it concluded separate recognition of intangible assets, on the basis of an estimate of fair value, rather than subsuming them in goodwill, provides better information to the users of financial statements even if a significant degree of judgement is required to estimate fair value.

45. For the reasons in paragraphs 43-44 the staff think if we choose to subsume additional intangible assets in goodwill it would need to be for cost-benefit reasons (ie Approach 2), not reliability of measurement.

46. The staff also note that one of the reasons for the removal of the reliability of measurement criterion in 2008 was to enable convergence with the US (see paragraph BC172-BC174 accompanying IFRS 3(2008)). The FASB are not considering

[3] Paragraph 71 of IASB Agenda Paper 2B for the September 2006 IASB meeting.

introducing a reliability of measurement criterion as one of their views (see paragraph 10). Consequently pursuing Approach 3 would probably result in divergence between the Board's converged Standards.

Approach 4—Allow further grouping of intangible assets

47. Paragraph 37 of IAS 38 permits an acquirer to recognise a group of complementary intangible assets as a single asset provided the individual assets have similar useful lives. We could consider relaxing the requirements in paragraph 37 of IAS 38 for combining intangible assets together as a single asset. This might permit accounting for intangible assets that are difficult to value on an individual basis together with other intangible assets (as a 'portfolio' of intangibles).

Staff view

48. Some respondents suggested this approach because of concerns that relationships between some intangible assets make it difficult to value them separately from each other. However the staff are concerned that grouping dissimilar items together, with different useful lives, different risks and different cash flows would not be a faithful representation of the intangible assets acquired in the business combinations. For finite life intangibles, incorporating assets together would also add complexity when determining an amortisation method and period that reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

49. For example there often interrelations between intangible assets such as customer relationships, customer lists and brands. However, one would expect that brands and customer relationships/lists could have dramatically different useful lives (a longer one for a brand and a shorter one for the customer relationships).

50. The FASB are not considering Approach 4. Consequently pursuing Approach 4 may result in divergence between the Boards' converged Standards.

51. The staff note that paragraph 36 of IAS 38 states that an intangible asset acquired in a business combination might be separable, but only together with a related contract, identifiable asset or liability. In such cases, the acquirer recognises the intangible asset separately from goodwill, but together with the related item. The staff think that no further relaxation of the requirements in paragraphs 36-37 of IAS 38 is necessary.

Guidance on customer relationships

52. The staff suggest that one area where the IASB should consider providing or clarifying guidance is on customer relationship intangibles:

    (a) In 2008/2009 the IFRIC[4] discussed 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. The IFRIC suggested that this issue should be address by the IASB and FASB. The IASB deferred addressing the issue pending feedback from the PIR (See IFRIC agenda decision in Appendix C).

    (b) Customer relationships are often asserted to be the most challenging intangible assets to measure separately.

    (c) According to a report published by the European Securities and Markets Authority (ESMA)[5] in June 2014, on the basis of its review the most prevalent intangible asset recognised separately from goodwill related to customer relationships and customer relationships play a significant role in business combination.

53. Under the current requirements contractual customer relationships are always recognised separately from goodwill as they meet the contractual-legal criterion. However, non-contractual customer relationships are recognised separately from goodwill only if they meet the separable criterion. Consequently, determining whether a relationship is contractual or not could lead to a significantly different accounting outcome.

54. The submission to the IFRIC raised concerns that different views exist in practice about the classification of customer relationships as contractual or non-contractual and that it is not clear how broad a range of contracts the IASB intended to cover. For example:

    (a) A customer relationship normally requires the existence of a customer with a history of prior transactions. Under many jurisdictions transactions are

[4] The IFRS Interpretations Committee was previously called the IFRIC.

[5] ESMA Report: Review on the application of accounting requirements for business combinations in IFRS financial statements

considered to be contractual under common law, even in the absence of a formal signed contract. Consequently some think all customer relationships could be interpreted to be contractual.

(b) Another view is that the IASB did not intend contractual customer relationships to cover such a broad range of relationships between entities and their customers, for example it may have intended there to be a formal written contract.

55. The submission explained the contractual/non-contractual distinction under IFRS is crucial because the legal environment in many countries makes it impossible to sell groups of customers (ie they are not separable).

56. A staff survey of IFRIC members in 2008 confirmed that diversity appeared to exist in practice. In addition, it appeared valuation experts were taking different views, which could also be contributing to diversity in accounting. The main area of potential confusion appears to be when transactions with customers result from short term purchase order or retail sales rather than longer term contracts.

57. The IFRIC decided sufficient confusion and diversity in practice existed to warrant attention but that it should be resolved by referring it to the IASB and FASB with a recommendation to review and amend IFRS 3 by:

(a) removing the distinction between ‘contractual’ and ‘non-contractual’ customer-related intangible assets recognised in a business combination; and

(b) reviewing the indicators that identify the existence of a customer relationship in paragraph IE28 of IFRS 3 and including them in the Standard.

58. The staff think the IASB should clarify its intent in IFRS for customer relationships, before deciding whether to subsume any customer relationships or other customer-related intangibles in goodwill. When clarifying its intent of which customer relationships should be measured separately from goodwill, the IASB could consider including criteria that would narrow down those customer relationships that meet the contractual/legal criteria (the staff notes this may result in a similar outcome as View B4 of the FASB in paragraph 10(b)(iv)). This may relieve some of the concerns about

separately measuring customer relationships without needing to directly change the requirements in IFRS 3.

59. Nevertheless the staff note that it would be difficult for the IASB to directly clarify what it means by ‘contractual’ customer relationships in IFRS 3/IAS 38 because several other Standards already provide guidance on what is considered a contract. For example IFRS 15 *Revenue* defines a contract ‘as an agreement between two or more parties that creates enforceable rights and obligations’. Paragraph 13 of IAS 32 states that for the purpose of IAS 32 ‘contract’ and ‘contractual’ refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.’

60. The staff think that clarifying the guidance in IFRS 3(2008) would be best considered jointly with the FASB to avoid divergence in practice between the Board’s Standards.

Addressing users concerns about the current information provided

61. Some users have told us that there is insufficient information about the assumptions used in valuations models for intangible assets and in the assessment of their useful lives. Some noted that it would be useful to require the disclosures in IFRS 13 *Fair Value Measurement* on valuation techniques and inputs (business combinations do not fall within the disclosure requirements of IFRS 13).

62. Some users say that valuations of some intangible assets have little credibility because they are highly subjective. However if disclosures about the assumptions used in valuation models and about the models themselves were improved, the staff think this would make the valuations more useful to users.

63. The staff note that there is criticism by preparers that IFRS 3 already requires too much disclosure. Consequently in addition to considering whether we can add disclosures, we should also assess whether existing disclosure requirements in IFRS 3 are still relevant and justified from a cost-benefit perspective.

64. Although some users do not find the fair value information about some intangible assets useful, most generally do not have concerns about those intangible assets being recognised separately from goodwill (which is really just providing them with additional information). The main concern expressed about recognising intangibles separately from goodwill seems to be relating to the impact of amortisation on the income statement.

65. As explained in paragraph 22(f) under Approach 1 some users have concerns that amortising intangible assets that are considered to be continually replaced by the entity (eg brands and customer relationships) results in double counting of expenses. This is because an entity will expense both amortisation and the expense incurred to grow new intangible assets or maintain existing ones, for example sales and marketing expenses. For this reason amortisation on these acquired intangibles (sometimes referred to as purchase price allocation (PPA) amortisation) is sometimes added back by preparers and users to derive an underlying earnings number. However often these users think that other intangibles such as licences, patents and software should be recognised separately because they require large capital expenditure to be replaced. In their view, the recognition and amortisation of these assets is appropriate, because it is a proxy for the replacement cost of the asset.

66. Some users say it is difficult for users to differentiate between amortisation they want to add back and amortisation on intangibles that they wish to keep in profit. The staff note this is a common concern expressed by users. Nevertheless the staff thinks that sufficient information should be available in the intangible asset reconciliation required by IAS 38 for users to be able to add back amortisation on different types of intangible assets if they wish to do. This reconciliation is required by class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets (see paragraph 118(e) of IAS 38).

Staff recommendations and questions for the IASB

67. The staff support Approach 1, not subsuming any identifiable intangible assets in goodwill (no change to the existing requirements). However the staff think that before making any decisions the IASB should discuss Approach 2, in particular whether any customer related intangibles should be subsumed in goodwill, at a joint meeting with

the FASB to avoid divergence between the Boards' converged Standards. The staff do not recommend pursuing Approaches 3 or 4 further.

68. The staff also suggest that the IASB should work with the FASB to consider whether there is a need to clarify the requirements for customer relationships and also consider whether further guidance or education material could be developed to address other issues. If the IASB considers this on its own it should limit considerations to education material to avoid divergence.

69. The staff also suggest considering the following improvements to disclosures:

(a) Considering the IFRS 13 disclosures for significant intangible assets.

(b) Assess whether existing disclosure requirements in IFRS 3 are still relevant or justified from a cost-benefit perspective and also by considering them against the disclosure objective in IFRS 3.

70. As noted above the staff only ask the IASB to discuss their views on approaches at this meeting and to identify what additional information they require to be able to develop views on these approaches.

Questions
1) Do IASB members need any further information before developing views on which of the approaches they would like to consider further?
2) Do IASB members think they have enough information about these approaches, and have had sufficient discussion, to be ready for a discussion with the FASB?

[Appendices A-D are in Agenda Paper 18C]