

STAFF PAPER

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IASB Meeting

Project	Goodwill and impairment project		
Paper topic	Customer relationships acquired in a business combination		
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Objective of this paper

1. The purpose of this agenda paper is to describe an issue discussed by the IFRIC¹ on customer relationships acquired in a business combination and provide staff analysis and recommendations for how the Board could address the issue.
2. The staff is not asking Board members to make any decisions on this agenda paper. The staff recommend decisions about potential amendments to IFRS 3 *Business Combinations* are best taken jointly with the US Financial Accounting Standards Board (FASB) at a later meeting to maintain convergence.

Structure of this paper

3. This paper includes the following sections:
 - (a) Introduction
 - (b) Why should we consider clarifying the requirements for customer relationships?
 - (c) Current requirements for recognition of customer relationships in a business combination
 - (d) IFRIC discussion

¹ The IFRS Interpretations Committee was previously called the IFRIC

- (e) Staff analysis
- (f) Staff recommendation and question
- (g) Appendices:
 - (i) A: IFRIC agenda decision in March 2009 IFRIC update newsletter
 - (ii) B: Extract from Illustrative Examples accompanying IFRS 3

Introduction

4. In Agenda Paper 18A for the February 2016 Board meeting the staff included a section about clarifying guidance on customer relationships, a type of customer-related intangible asset. The section was based on a request discussed by the IFRIC in 2008/2009 to provide guidance on the circumstances in which a non-contractual customer relationship arises in a business combination. The IFRIC concluded that the issue should be addressed by the Board and the FASB. However, at the time the Board deferred addressing the issue pending feedback from the Post-implementation Review (PIR) of IFRS 3.
5. The staff further note that one of the subviews being discussed by the FASB in their project on intangible assets in a business combination is narrowing the guidance on when a customer-related intangible asset meets the contractual/legal criterion for recognition. The intent being to exclude ongoing customer relationships associated with purchase-order-based or at-will customers. The staff think this subview may be based on similar concerns as raised to the IFRIC.
6. At the February 2016 Board meeting a few Board members asked for further information about the issue discussed by the IFRIC. Consequently the staff think it would be helpful for the Board to have another discussion of this issue and see if there are any further information needs before the joint meeting with the FASB.

Why should we consider clarifying the requirements for customer relationships?

7. The PIR identified concerns that some intangible assets are costly, complex and time-consuming for entities 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. Preparers, users and other parties most frequently cited customer relationships as the type of intangible assets to which these concerns apply (followed by brands and customer lists). Some respondents specifically questioned the relevance and highlighted the complexity of measuring non-contractual customer relationships separately from goodwill.
8. IFRS 3(2004) required an acquirer to recognise, separately from goodwill, only those identifiable intangible assets of an acquiree that can be measured reliably. Some respondents to the PIR noted that some customer relationships were not measured separately from goodwill under the previous version of IFRS 3, because of this exception for reliable measurement.
9. Customer relationships are often significant assets acquired in a business combination. In June 2014 the European and Securities Market Authority (ESMA) issued a report *Review on the application of accounting requirements for business combinations in IFRS financial statements*. In this report ESMA noted that the most prevalent intangible asset recognised separately from goodwill was customer relationships.²

Current requirements for recognition of customer relationships in a business combination

10. An acquirer is required to recognise, separately from goodwill, all identifiable intangible assets acquired in a business combination. Paragraph 12 of IAS 38 *Intangible Assets* states that an intangible asset is identifiable if it:
 - (a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or

² The report was based on a review of 56 European listed entities from 11 jurisdictions, covering 66 businesses combinations reported in their 2012 IFRS financial statements. The sample was selected by first identifying 45 European issuers that had the most significant business combinations in that period. European Enforcers then added 11 smaller issuers with material business combinations so that the sample included a wider range of larger and smaller business combinations.

together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

- (b) 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.

11. The illustrative examples accompanying IFRS 3 provide examples of identifiable intangible assets acquired in a business combination. Paragraph IE23 provides the following examples of customer-related intangible assets:

Class	Basis
Customer lists	Non-contractual
Order or production backlog	Contractual
Customer contracts and related customer relationships	Contractual
Non-contractual customer relationships	Non-contractual

12. Consequently paragraph IE23 indicates that customer relationships could be contractual or non-contractual. In accordance with paragraph 10 above:
- (a) Contractual customer relationships are always recognised separately from goodwill as they meet the contractual-legal criterion.
 - (b) Non-contractual customer relationships are only recognised separately from goodwill if they meet the separable criterion.

IFRIC discussion

13. 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 customer relationships the Board intended to cover as being contractual. For example:
- (a) Some think all customer relationships could be interpreted to be contractual. A customer relationship normally requires the existence of a customer with a history of prior transactions. Under many jurisdictions transactions are considered to be contractual under common law, even in the absence of a formal signed contract.

- (b) Another view is that the Board 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.
14. 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).
 15. A staff survey of IFRIC members in 2008 confirmed that diversity appeared to exist in practice regarding which customer relationships are considered to have a contractual basis and which are non-contractual. 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.
 16. In 2008, the IFRIC staff also held discussions with valuation practitioners in the US and UK from two of the larger accounting firms to understand their experiences with, including what they see in practice for, non-contractual customer relationships. Though informal, some of the experiences shared with the staff include the following³:
 - (a) intangibles of significant values typically include trade names and contractual customer relationships (income valuation approach);
 - (b) customer lists are of little value (cost replacement valuation approach), and non-contractual customer relationships (residual income valuation approach) are uncommon and not significantly valued;
 - (c) a customer loyalty program was cited as an example of non-contractual customer relationships but mixed views on the valuation;
 - (d) depositor' relationships and related deposit liabilities are not sold as a single asset group outside of business combinations;

³ This list is taken from paragraph 45 of Agenda Paper 4 for the November 2008 IFRIC meeting

- (e) customer relationships with ‘pay-as-you-go’ mobile customers are viewed as non-contractual. However, it was noted that it is questionable whether a customer relationship exists if mobile providers do not know the identity or contact details of the customers; and
 - (f) when non-contractual customer relationships are identified, often the entity has insufficient information to value them and recognise them separately from goodwill.
17. The IFRIC decided sufficient confusion and diversity in practice existed to warrant attention but that it should be resolved by referring it to the Board and the 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 guidance that identifies the existence of a customer relationship in paragraph IE28 of IFRS 3 and including it in the Standard.

Staff analysis

18. The staff think if the Board and the FASB decide not to subsume customer relationships in goodwill as part of this project, they should discuss their intent regarding which customer relationships should be measured separately from goodwill.
19. The staff do not think the Board should clarify what it means by ‘contractual’ customer relationships in IFRS 3/IAS 38 because other Standards already provide guidance on what is considered a contract. Consequently it would be difficult for the Board to interpret ‘contractual’ differently in IFRS 3/IAS 38 for customer relationships. 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.’

20. The notion of *legally enforceable* includes spoken and implied agreements. The staff think this notion could result in all customer relationships being ‘contractual’ and so required to be recognised, separately from goodwill, at fair value. The staff does not think this is what the Board intended because the Board made reference to non-contractual customer relationships in the illustrative examples accompanying IFRS 3 (see paragraph 11).
21. The staff note that even if ‘contractual’ is interpreted as a written offer and acceptance, this could still encompass most customer relationships. For example, the staff think that the following could all be considered a written offer and acceptance between the customer and the entity:
 - (a) an order for a delivery sent over the internet;
 - (b) a sales receipt printed in the store for a walk-in cash purchase;
 - (c) an agreement opening a bank deposit account; and
 - (d) a utility or mobile service agreement.
22. The staff think that customer loyalty programs could also be considered contractual on a similar basis because of the related sale receipts (even though they were provided as an example of a non-contractual customer relationship by respondents in the outreach in paragraph 16). Consequently the staff think if ‘contractual’ is interpreted as a written offer and acceptance, non-contractual customer relationships might be limited to prospective customers who have never purchased from the entity. The staff question whether customer relationships exist, and can be measured, with prospective customers.
23. For the above reasons, rather than clarifying what was intended by ‘contractual’ customer relationships, the staff think the best way to address this issue would be to define a customer relationship in the body of the Standard. This could be done by:
 - (a) Providing a description of what a customer relationship asset is. The staff think this is the future economic benefits in the form of future business with

a customer beyond the amount secured by any current contractual arrangement.

- (b) Including the wording “A customer relationship exists between an entity and its customer if the entity has information about the customer and has regular contact with the customer” from paragraph IE28 in the body of the Standard, thereby making the wording mandatory. The staff think this would narrow down the definition of a customer relationship and exclude situations such as anonymous walk in customers. The wording would also make it easier to identify and measure customer relationship.

If the definition is not met, a customer relationship would not be recognised separately from goodwill (ie it would be included as part of the going concern component of goodwill).

24. The staff further think that references to non-contractual customer relationships should be removed from the Standard to avoid concerns about whether customer relationships can ever be non-contractual.
25. Using the definition in paragraph 23, the staff cannot think of an example of a customer relationship that is both non-contractual and separable. Consequently, the staff think that only contractual customer relationships would be recognised separately in a business combination under the definition in paragraph 23.
26. The staff think that the suggestions in paragraph 23(b) and paragraph 24 are in line with what was intended by the IFRIC in their agenda decision in March 2009 (see Appendix A).

Staff recommendation and question

27. The staff recommend adding the following to the body of IFRS 3/IAS 38 to clarify what is meant by a customer relationship:

A customer relationship:

- represents the future economic benefits in the form of future business with a customer beyond the amount secured by any current contractual arrangement.
- exists between an entity and its customer if the entity has information about the customer and has regular contact with the customer.

28. The staff also recommend removing the reference to non-contractual customer relationships in the illustrative example to IFRS 3. This would include deleting the last item in the table in paragraph IE23 and deleting paragraph IE31.
29. The staff think that the Board should discuss the issue with the FASB before making any decisions to avoid divergence between the Boards' Standards.

Question for the Board

- 1) Do Board members think they have enough information about this issue to be ready for a discussion with the FASB?

Appendix A: IFRIC agenda decision in March 2009 IFRIC update newsletter

- A1. The following IFRIC agenda decision⁴ has been extracted from the March 2009 edition of IFRIC update.

IFRS 3 Business Combinations—Customer-related intangible assets

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

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

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

⁴ IFRIC agenda decisions are not Interpretations.

inputs in valuing a customer relationship intangible asset but should not determine whether it is recognised.

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

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

Appendix B: Extract from Illustrative Examples accompanying IFRS 3

Customer-related intangible assets

IE23 Examples of customer-related intangible assets are:

Class	Basis
Customer lists	Non-contractual
Order or production backlog	Contractual
Customer contracts and related customer relationships	Contractual
Non-contractual customer relationships	Non-contractual

Customer lists

IE24 A customer list consists of information about customers, such as their names and contact information. A customer list also may be in the form of a database that includes other information about the customers, such as their order histories and demographic information. A customer list does not usually arise from contractual or other legal rights. However, customer lists are often leased or exchanged. Therefore, a customer list acquired in a business combination normally meets the separability criterion.

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 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) Acquirer Company (AC) acquires Target Company (TC) in a business combination on 31 December 20X5. TC has a five-year agreement to supply goods to Customer. Both TC and AC believe that Customer will renew the agreement at the end of the current contract. The agreement is not separable.

The agreement, whether cancellable or not, meets the contractual-legal criterion. Additionally, because TC establishes its relationship with Customer through a contract, not only the agreement itself but also TC's customer relationship with Customer meet the contractual-legal criterion.

- (b) AC acquires TC in a business combination on 31 December 20X5. TC manufactures goods in two distinct lines of business: sporting goods and electronics. Customer purchases both sporting goods and electronics from TC. TC has a contract with Customer to be its exclusive provider of sporting goods but has no contract for the supply of electronics to Customer. Both TC and AC believe that only one overall customer relationship exists between TC and Customer.

The contract to be Customer's exclusive supplier of sporting goods, whether cancellable or not, meets the contractual-legal criterion. Additionally, because TC establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal criterion. Because TC has only one customer relationship with Customer, the fair value of that relationship incorporates assumptions about TC's relationship with Customer related to both sporting goods and electronics. However, if AC determines that the customer relationships with Customer for sporting goods and for electronics are separate from each other, AC would assess whether the customer relationship for electronics meets the separability criterion for identification as an intangible asset.

- (c) AC acquires TC in a business combination on 31 December 20X5. TC does business with its customers solely through purchase and sales orders. At 31 December 20X5, TC has a backlog of customer purchase orders from 60 per cent of its customers, all of whom are recurring customers. The other 40 per cent of TC's customers are also recurring customers. However, as of 31 December 20X5, TC has no open purchase orders or other contracts with those customers.

Regardless of whether they are cancellable or not, the purchase orders from 60 per cent of TC's customers meet the contractual-legal criterion. Additionally, because TC has established its relationship with 60 per cent of its customers through contracts, not only the purchase orders but also TC's customer relationships meet the contractual-legal criterion. Because TC has a practice of establishing contracts with the remaining 40 per cent of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though TC does not have contracts with those customers at 31 December 20X5.

- (d) AC acquires TC, an insurer, in a business combination on 31 December 20X5. TC has a portfolio of one-year motor insurance contracts that are cancellable by policyholders.

Because TC establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion. IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets* apply to the customer relationship intangible asset.

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.