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IMPLEMENTATION CHALLENGES IN APPLYING THE CONSENSUS IN EITF ISSUE 02-17: RECOGNITION OF CUSTOMER RELATIONSHIP INTANGIBLE ASSETS ACQUIRED IN A BUSINESS COMBINATION

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Teresa served as a member of the AICPA's SEC Regulations Committee from 1997 until 1999, the FASB's Emerging Issues Task Force from 1999 until 2001, and the American Accounting Association's Financial Accounting Standards Board from 2000 until 2003. She currently serves on the PCAOB Subcommittee of the Securities Law Committee of the American Society of Corporate Secretaries, the editorial and advisory board of *Accounting Horizons*, a publication of the American Accounting Association, and on the University of Maryland's Board of Visitors. She is a member of the American Institute of Certified Public Accountants and the American Accounting Association.

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Speaker: Ms. Teresa Iannaconi

I would like to begin by expressing my appreciation for the opportunity to participate in the Emanuel Saxe Distinguished Lecture Series. Baruch College and the Emanuel Saxe Lecture Series enjoy a reputation for outstanding scholarship and leadership in accounting. I felt awed at the prospect of making a presentation to this group. After some consideration I concluded that it would be interesting to take a look at a particular aspect of evolving accounting literature as an insight into the intellectual and political processes of standard setting. To that end I decided to address the evolution and implementation of a recent FASB Emerging Issues Task Force (EITF) consensus that was generated by the need for interpretive guidance to address the relatively new financial accounting standard on business combinations.

The adoption of FASB Statement No.141, *Business Combinations*, marked a major change in accounting for business combinations. After decades of criticism and debate about the merits of accounting for some business combinations using the "pooling of interests" method, SFAS 141 concluded that all business combinations should be accounted for as purchases at fair value. Prior to SFAS 141 many companies structured business combinations to permit "pooling of interests" accounting because that method allowed the historical financial statements of the combining enterprises to be brought together at the historical cost bases of the assets and liabilities, thus avoiding revaluation of the assets and liabilities. By avoiding revaluation of assets, the continuing book values of net assets were usually carried forward at amounts that were substantially lower than their fair values (e.g. appreciated values of property, inventory, investments, licenses and patents were not required to be recognized). Additionally, pooling accounting avoided recognizing some intangible assets. For example, if the acquired company had goodwill or significant internally developed intangibles such as customer lists, technology, or brand names, such assets would be recognized under purchase accounting but not under pooling accounting.

The incentive for avoiding purchase accounting and the accompanying fair valuation of assets and liabilities was that the usual "step-up" in assets resulted in additional asset basis that was required to be depreciated or amortized through the income statement as an expense with the resultant reduction of net income. Because pooling accounting avoided asset step ups and the attendant additional depreciation and amortization, post combination earnings were higher.

While SFAS 141 eliminated the pooling accounting, FASB Statement No. 142, Goodwill and Intangible Assets (SFAS 142) established that goodwill would not be subject to periodic systematic amortization but would be subject to annual evaluation for impairment. The interplay of the provisions of SFAS 141 and 142 resulted in a predisposition by combining companies to allocate as little of the purchase price as possible to assets other than goodwill and to maximize the amount allocated to goodwill.

SFAS 141 became effective for new combinations on July 1, 2001. SFAS 142 became effective for calendar year end companies on January 1, 2002. It took little time to identify the first round of implementation challenges in the application of SFAS 141. In summer of 2002 the FASB's Emerging Issues Task Force (EITF) added to their agenda for consideration an issue to address allocation of purchase price to an intangible asset characterized as the "customer relationship intangible" asset. The issue arose from ambiguity in language in SFAS 141 concerning limitations on the types of intangible assets that are permitted to be recognized. Paragraph 39 of SFAS 141 states that:

> *An intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired entity or from other rights and obligations). If an intangible asset does not arise from contractual or other legal rights, it shall be recognized as an asset apart from goodwill only if it is separable, that is, it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so). For purposes of this Statement, however, an intangible asset that cannot be sold, transferred, licensed, rented, or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset, or liability. For purposes of this Statement, an assembled workforce shall not be recognized as an intangible asset apart from goodwill. Appendix A provides additional guidance relating to the recognition of acquired intangible assets apart from goodwill, including an illustrative list of intangible assets that meet the recognition criteria in this paragraph.*

Appendix A of SFAS 141 includes implementation guidance to assist in identifying intangible assets. The relevant paragraphs A18 through A21 state as follows:

Customer-Related Intangible Assets

Customer lists

> *A18. A customer list consists of information about customers such as their name 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 history and demographic information. A customer list does not generally arise from contractual or other legal rights. However, customer lists are valuable and are frequently leased or exchanged. Therefore, an acquired customer list would meet the separability criterion for recognition apart from goodwill. An acquired customer list would not meet that criterion, however, if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its customers.*

Order or production backlog

> *A19. If an acquired order or production backlog arises from contracts such as purchase or sales orders, it meets the contractual-legal criterion for recognition apart from goodwill (even if the purchase or sales orders were cancelable).*

Customer contracts and related customer relationships

> *A20. If an entity establishes relationships with its customers through contracts, those customer relationships would arise from contractual rights. Therefore, customer contracts and the related customer relationships are intangible assets that meet the contractual-legal criterion. This Statement requires that those intangible assets be recognized as assets apart from goodwill even if confidentiality or other contractual terms prohibit the sale or transfer of the contract separately from the acquired entity.*

Noncontractual customer relationships

> *A21. If a customer relationship does not arise from a contract, this Statement requires that the relationship be recognized as an intangible asset apart from goodwill if it meets the separability*

criterion. Exchange transactions for the same asset or a similar type of asset provide evidence of separability of a noncontractual customer relationship and might also provide information about exchange prices that should be considered when estimating its fair value. For example, relationships with depositors are frequently exchanged with the related deposits and, thus, meet the criteria for recognition as an intangible asset apart from goodwill.

The glossary to SFAS 141 defines "customer relationship" as follows:

For purposes of this Statement, 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. Relationships may arise from contracts (such as supplier contracts and service contracts). However, customer relationships may arise through means other than contracts, such as through regular contact by sales or service representatives.

Although paragraph 39 established a need to meet a contractual, legal or separable criterion, the implementation guidance in Appendix A and the definition in the glossary raised questions as to how these criteria were to be interpreted and applied. Paragraph A18 provides an example of a separable customer related intangible in the form of a customer list while paragraphs A19 and A20 provide examples of contractual based customer relationship intangibles. Paragraph A21 identifies bank customer deposits intangibles as requiring recognition based on the historical evidence that financial institutions do in fact "sell" these relationships together with the underlying deposits that are, therefore, demonstrably separable from the enterprise.

As indicated above, in summer of 2002 the EITF added an issue to its agenda to consider when and how to recognize a customer relationship intangible in a business combination. That issue, identified as EITF Issue No. 02-17: *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*, was discussed at the EITF meetings in September and October of 2002. The EITF Abstracts identify three issues considered by the EITF:

Issue 1-When an entity recognizes an intangible asset pursuant to paragraph 39 of Statement 141, whether the contractual-legal or the separability criteria restrict the use of certain assumptions, such as expectations of future contract renewals and other benefits related to the intangible asset that would be used in estimating the fair value of that intangible asset

Issue 2-Whether the guidance in Statement 141, paragraph A20, which states that a customer relationship meets the contractual-legal criterion if an entity establishes relationships with its customers through contracts, applies only if a contract is in existence at the date of acquisition

Issue 3-Whether order or production backlogs arising from contracts such as purchase or sales orders (even if the purchase or sales orders are cancelable) as described in paragraph A19 of Statement 141 are considered contracts subject to the guidance in paragraph A20 of Statement 141.

The EITF reached consensuses with respect to these issues, which are summarized as follows:

Issue 1 The contractual-legal and separability criteria are to be used to determine whether there is an intangible asset but do not impact the valuation of the intangible asset. If the customer relationship intangible is found to exist because it meets the criteria, the valuation should be at fair value; that is, it should be based on assumptions that other market participants would use, including assumptions about renewals or other benefits arising from the relationship. In other words, once the intangible asset has been identified using the contractual-legal and separability criteria, the valuation of the intangible asset is not limited by the current existence or terms of a particular contract.

Issue 2 The contractual-legal criterion is met if an entity has a practice of establishing contracts with customers regardless of whether there is a contract in place at the date of the business combination.

Issue 3 Order or production backlogs do give rise to contractual-legal rights and therefore meet the contractual-legal criterion.

The EITF consensus also observes that a customer contract and the related customer relationship may represent two distinct assets that must be valued and amortized based on the attributes of the separate assets.

Implementation examples

The EITF consensus abstract provides some general examples of the application of the consensus. However, we would like to amplify the available examples based on some "real life" issues that have been addressed in our national office.

Example 1: A company that is a local newspaper publisher sells newspapers through two channels. The first channel consists of sales through newsstands where the publisher has an arrangement to drop off a fixed number of copies each morning and pick up unsold copies for credit each evening. The newsstand operator is a distributor but not a customer. The publisher also delivers newspapers to individual subscribers who receive home delivery and pay monthly.

The newspaper derives revenue from newspaper sales but it also derives revenue from advertising. Customer relationships fall into three buckets: newsstand sales, subscription revenues, and advertising revenues. In applying EITF 02-17, there appears to be a contractual-legal component to subscribers and advertisers but not to newsstand customers. Thus a customer relationship intangible can be identified for those two elements. The valuation of those two customer relationship intangibles would then be based on an assessment of the amount that a market participant would be willing to pay for those relationships.

Example 2: A contract trucking company provides truck transportation services on varying long-term and short-term bases. Although a significant part of the business involves multi-year contracts in which the company designates particular equipment to a contract and applies customer designs and signage to the trucks, other customers contract on a one-time or short-term basis but with a high level of repeat business customers over time. The trucking company is acquired in a purchase business combination. The purchaser must assess whether there is a customer relationship intangible and, if so, how to value it.

Based on the facts provided, substantially all of the business is on a contract basis and a customer relationship intangible would be recognized. The valuation of the intangible would not be limited to contracts in force at the date of the acquisition but would also look at the value of other repeat customers who have had recurring contractual relationships. In fact, there may be two intangible assets that must be recognized-one for the contractual relationships that are in place at the date of acquisition, and another separate customer relationship intangible for the repeat business from customers with current and multi-year contracts.

Example 3: A vendor manufactures two lines of products, sporting goods and consumer electronics. The vendor has a contract under which it sells sporting goods to a discount retailer that does not currently purchase any consumer electronics from the vendor. The vendor is purchased and the purchase price must be allocated. A customer relationship intangible is identified for the sporting goods contract. But a question arises as to whether an intangible should be recognized for the cross selling opportunity to sell electronics to the same discount retailer. The cross selling potential exists but would not be recognized because there is no past purchases of electronics by the retailer to demonstrate the existence of the intangible at the date of the business acquisition.

Valuation and Amortization Challenges

Once the customer relationship intangible has been identified, it must be valued and a useful life must be determined. The consensus in EITF 02-17 notes that fair value should reflect what a willing market participant would pay for the relationship. Because it may not be possible to obtain bids on intangible assets, a number of surrogate valuation methods have been suggested and explored. The valuation methods fall into two categories; cost methods and income methods. Cost methods approach valuation from a perspective of what would it cost to build the customer relationship, essentially a cost avoidance valuation method. The SEC has generally rejected this approach because it believes it is not applied rigorously in practice. Rather, the SEC requires public companies to use an income method. The latter attempts to estimate fair value based on an estimate of future income benefits. The future benefits are determined by forecasting future earnings net of reasonable allocations of costs of earning the revenue and further adjusted for a reasonable required cost of capital. In applying the income methods, however, the SEC has rejected approaches where cost allocations result in turning the calculation into a "residual method" where the customer relationship intangible is the residual after all other synergies have been satisfied via built-in cost allocations.

Some companies rely on appraisals by experts to support purchase price allocations that include customer relationship intangibles. However, the SEC staff has challenged valuations, even those based on expert appraisals, where it believes the methodologies are replacement cost or residual-based, or where it does not concur with the cost allocations.

Whatever valuation methodology is used, that methodology is likely to include assumptions about cash flows and/or earnings over some time period. The period used for valuation presumably creates a presumption that the same period is the useful life of the asset and should be used as the amortization period. Use of another amortization period would call into question the integrity of the benefit period used for valuation.

Indefinite Lived Intangibles

Some companies have asserted that strong customer relationships give rise to intangible assets with indefinite useful lives that would not be amortized. Chad A. Kokenge, a professional accounting fellow at the SEC, indicated in a recent speech that the SEC staff believes an indefinite useful life for a customer relationship intangible would be extremely rare.(1) He cited a number of factors that should be considered in determining whether a customer relationship intangible has an indefinite useful life. Among the factors cited were the fact that the intangible is inherently related to people relationships and within organizations in which personnel changes are expected. Historical customer churn rates should also be considered. Additional factors to consider include high costs or penalties of customer terminations, and economic conditions such as competition and resource availability.

Conclusion

New challenges and issues result from the FASB prohibiting pooling accounting for business combinations and goodwill amortization. The distinction between amortizing intangibles and non-amortizing goodwill has motivated acquiring businesses to maximize the amount of purchase price that is allocated to non-amortizing goodwill. As a result, the SEC has challenged purchase price allocations that do not recognize significant other intangible assets. Companies are increasingly challenged to perform rigorous analyses to identify the existence, valuation, and useful lives of other intangibles, including customer relationship intangibles. As more purchase price is allocated to amortizing intangibles, especially customer relationship intangible assets with relatively short useful lives, amortization expense on the intangible assets may exceed the amortization expense on previously recognized goodwill. In some respects, one might view the evolution of accounting for business combinations as shortening the life of a significant amount of goodwill rather than eliminating amortization.

Endnote

1 Speech by Chad A. Kokenge, Professional Accounting Fellow, Securities and Exchange Commission; AICPA SEC Current Developments Conference, Washington, DC, December 11, 2003.