FINANCIAL ACCOUNTING STANDARDS BOARD

Memo

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Project	**Identifiable Intangible Assets in a Business Combination for Public Business Entities and Not-for-Profit Entities**
Project Stage	**Initial Deliberations**
Issue(s)	**Project Update**

Purpose of This Memo

1. The purpose of this memo is to provide a summary to the Boards of progress to date by the FASB on the accounting for identifiable intangible assets in a business combination project. The project is currently in the initial deliberations stage. This is a non-decision-making meeting.

2. On November 5, 2014, the FASB added a project to its technical agenda for public business entities (PBEs) and not-for-profit entities (NFPs) on the accounting for identifiable intangible assets in a business combination. At that time, the FASB asked the staff to consider the implications of potentially subsuming certain intangible assets into goodwill. The project was added to the FASB's agenda at the same meeting the FASB endorsed the Private Company Council (PCC) consensus to change generally accepted accounting principles (GAAP) for private companies on the accounting for identifiable intangible assets in a business combination. The objective of this project is to evaluate whether the recognition and measurement requirements for acquired intangible assets also should be simplified for

PBEs and NFPs. The FASB discussed this project at its October 28, 2015 meeting and decided to continue working on this project by engaging with the international community.

3. This memo is organized as follows:

   (a) Summary of outreach activities and research

   (c) Summary of options considered to date:

      (i) View A—No intangibles except those capable of being sold or licensed independently from other assets of the business

      (ii) View B—No change to GAAP.

   (d) Appendix A—Summary of the FASB's past projects on the accounting for identifiable intangibles in a business combination.

Summary of Outreach Activities and Research

4. For PBEs, the FASB staff reviewed relevant comment letter responses and bases for conclusions from previous projects on identifiable intangible assets. The staff conducted outreach with PBE and NFP stakeholders including users, the Investor Advisory Committee (IAC), preparers, and the Not-for-Profit Advisory Committee (NAC). The staff also performed research to obtain information about stakeholder views during deliberations that lead to FASB Statements No. 141, *Business Combinations*, and No. 141 (revised 2007), *Business Combinations*.

5. Users comprising the FASB staff outreach included lenders, ratings agencies, and buy-side and sell-side analysts. At the request of a FASB member, the staff also looked at the feedback received by the IASB on its intangible asset project (which came primarily from the IASB's Post-implementation Review of International Financial Reporting Standards (IFRS) 3, *Business Combinations*) to see if there were identifiable differences in the types of users included. The FASB staff observes that the users included in the IASB staff's outreach included various financial analysts and analyst associations. The FASB staff notes that the

results of the user outreach for both GAAP and IFRS were mixed as well, and the proponent and opponent views did not appear isolated to a particular type of investor or analyst.

Users

6. Most PBE users preferred current GAAP to any of the proposed alternatives to subsume intangible assets into goodwill. However, similar to users of private company and NFP financial statements, users of PBE financial statements had mixed views on the usefulness of information of the fair value of intangible assets. Responses on the importance and usefulness of fair value information of particular intangible assets also varied significantly depending on the industry considered.

7. Many users—primarily equity investors and analysts—had concerns about any potential changes to simplify the accounting for intangible assets in a business combination. Those users highlighted that many entities in the current economy are driven by the creation and use of intangible assets (for example, intellectual property). Those users stated that they find intangible assets to provide decision-useful information. They are interested in the types of intangible assets and value of intangible assets (that is, what the acquirer paid for them). Those users indicated that goodwill should be shown separately from other intangible assets that have distinct characteristics. For example, intangibles including trademarks, patents, and brands can be considered more important than goodwill.

8. Many of those users highlighted that one issue is that certain intangible assets are inherently difficult to value. However, they indicated that both fair value and historical cost provide relevant information to users and they would find it helpful to understand more detail about how management values intangible assets in acquisitions. Other users, including investors and analysts, however, indicated that the value of some intangible assets does not provide decision-useful information for a variety of reasons, including subjectivity and reliability of the valuations and relevance to particular industries.

9. Unlike users of private company financial statements, most users of PBE financial statements felt that they do not generally have access to management. Accordingly, they would not be

able to obtain information on unrecognized intangible assets beyond any information disclosed in footnotes.

IAC

10. IAC members were interviewed on the topic of intangible assets as part of the PCC project on subsuming certain intangible assets into goodwill. Overall, the feedback received from IAC members (consisting primarily of analysts who follow financial institutions) was mixed. IAC members had differing views about whether a private company alternative should be extended to PBEs.
11. IAC members stated that some intangible assets can be relevant depending on the industry and that the performance of an impairment analysis and the potential recording of an impairment charge are perceived as ways to assess management accountability.
12. IAC members who were open to extending a proposed alternative to PBEs noted that users of PBE financial statements generally place limited reliance on the value of intangible assets separately from goodwill in the financial statements and that some intangible assets (such as customer relationships) can be difficult to separately value and are, therefore, often ignored by many analysts. Thus, the IAC members reasoned that reducing the number of recognized intangible assets would not deprive financial statements users of significant information. Those users also indicated that intangible assets typically represent a minor component of an acquisition, while goodwill generally results in a significant portion. The staff observes, however, that this is not always the case; in some acquisitions, intangibles are significant (for example, intangible assets obtained through the acquisition of a pharmaceutical entity could be much more significant than those obtained through the acquisition of a manufacturing entity).

Preparers

13. The staff performed outreach with preparers of PBEs from various industries, including financial services, technology, health care, and defense. The staff’s intent was to reach out to preparers from a variety of industries that had experience with conducting business

combinations and accounting for intangibles under current GAAP. Most PBE preparers indicated that they did not consider the one-time cost of determining the fair value of intangible assets acquired in a business combination to be significant in the context of a business combination.

14. PBE preparers stated that users rarely ask specific questions on the intangible assets recorded on their financial statements and that questions are generally related to impairment of assets. Some preparers also stated that they are interested in the existence of intangible assets owned by a target (for example, intellectual property) and consider those intangibles in estimating cash flows of the target.

NFPs

15. The staff notes that many NFPs do not recognize significant intangibles. For many NFPs, business combination activity is often considered a merger and no intangibles are recorded. However, for those NFPs that do engage in acquisitions, respondents generally note that the cost-benefit evaluations for intangible assets between private companies and NFPs are very similar and, therefore, any changes to recognition of intangible assets made for private companies also should apply to NFPs.

NAC

16. The staff discussed various alternatives for subsuming intangible assets into goodwill with the NAC at its March 10, 2014 meeting. Overall, NAC members agreed that NFPs should be permitted to apply the PCC alternative. Some members indicated concerns about the difficulty in the valuation of customer-related intangibles (CRIs) and noncompetition agreements (NCAs). NAC members acknowledged that a change to the accounting for identifiable intangible assets would most likely be limited to NFPs that are more "business like," (for example, health care entities, universities, and museums). Also, the business combination activity of many NFPs is often considered a merger, and no intangible assets are recorded. Despite the general support, one NAC member noted that comparability among

NFPs is important to users and, therefore, did not support having options within GAAP for NFPs.

Research

Statements 141and 141(R) and Post-Implementation Review (PIR) Findings on Statement 141(R)

17. The staff performed research to obtain information on stakeholder views about recognition of intangible assets and discussions by the FASB and staff that took place during deliberations that lead to Statements 141 and 141(R). The research included examining the basis for conclusions of those standards, reviewing comment letters to the proposals, and reviewing other related documents in the project files. The staff also reviewed the findings from the PIR on Statement 141(R) and the FASB's subsequent analysis of the PIR findings.

18. Paragraph B171 of Statement 141(R) states the following:

> Some respondents doubted their ability to reliably measure the fair values of many intangible assets. They suggested that the only intangible assets that should be recognized separately from goodwill are those that have direct cash flows and those that are bought and sold in observable exchange transactions. The FASB rejected that suggestion. Although the fair value measures of some identifiable intangibles assets might lack the precision of the measures for other assets, the FASB concluded that the information that will be provided by recognizing intangible assets at their estimated fair values is a more faithful representation than that which would be provided if those intangible assets were subsumed into goodwill. Moreover, including finite-lived intangible assets in goodwill that is not being amortized would further diminish the representational faithfulness of financial statements.

19. The PIR Report on Statement 141(R) indicated that both private companies and PBEs, particularly smaller PBEs, struggled with the measurement of intangible assets at fair value because that measurement can be complex. As a result, costs are being incurred to hire external valuation specialists to estimate the fair value of intangibles and auditors to test those values. Per the PIR Report, users of both public entities and private companies found the identification of separate intangibles useful, but noted that inconsistent application of FASB Statement No. 157, *Fair Value Measurements*, to the measurement of such intangibles could result in a lack of comparability and reliability. In response to the PIR Report, the FASB staff performed outreach and analyses to understand the specific concerns of

stakeholders and whether there were any cost-effective solutions to address those concerns. This memorandum includes the results of the FASB staff's outreach on the specific concerns of preparers and practitioners and the benefits that users receive from recognition of intangible assets.

Review of Academic Studies

20. The staff also reviewed several academic studies on intangible assets and found the research on intangible assets to be mixed. Historically, many studies have found a decline in the relevance of accounting information and attributed that decline to the economy becoming more intangible asset based while accounting recognizes few intangible assets outside of a business combination. Statement 141, which required the recognition of the fair value of intangible assets acquired in a business combination, was issued in large part because of some of this research. However, surveys of financial statement users are mixed in terms of whether the recognition of intangible assets in a business combination provides useful information, primarily due to the subjectivity involved in valuing intangibles as well as how quickly the information becomes irrelevant and not useful for future analysis. However, surveys of users indicate that there is a desire to know the value attributed to intangible assets at acquisition when the intangible assets are meaningful to an entity's future prospects and whether those intangible assets can be monetized. Other academic research supports recognition of internally generated intangible assets (that is, intangible assets created internally rather than limited to those that are acquired in a business combination). Those studies particularly point to research and development as creating an asset that should be recognized on an entity's balance sheet. However, some users observe that research and development spending does not always translate into asset value.

Summary of Options Considered to Date

21. The accounting for identifiable intangibles has changed considerably in the past. Throughout the staff's current outreach and review of comment letter responses and outreach on prior projects, the feedback on the accounting for identifiable intangible assets in business

combinations has consistently been varied. Many stakeholders consider the fair value of intangible assets to be decision-useful information at the time of an acquisition. While some stakeholders note that subsequent accounting for intangible assets is not useful, others found subsequent accounting for intangible assets to provide useful information, at least in certain circumstances; for example, acquisitions in industries with valuable intangible assets.

22. In a separate project, the FASB is considering changes in the subsequent accounting for goodwill, including amortizing goodwill. See FASB Memo No. 9 on the subsequent accounting for goodwill for additional information. The staff notes that if the FASB decides to include certain intangible assets in goodwill, it may influence the Board's decisions on the amortization of goodwill; likewise, if the FASB decides to amortize goodwill, it may influence the Board's decisions on whether or not to subsume any intangible assets.

23. The following views on potential changes to the accounting for identifiable intangible assets in business combinations for PBEs and NFPs have been discussed at prior FASB meetings:

    (a) View A—No intangibles, except those capable of being sold or licensed independently from other assets of the business: All intangibles would be subsumed into goodwill and other intangible assets, except those that are capable of generating cash flows separate and distinct from a business.

        (i) View A1—Principle: Intangible assets only would be separately recognized if they are capable of being sold or licensed independently from other assets of a business.

        (ii) View A2—Change limited to NCAs and CRIs: NCAs would not be recognized and CRIs only would be recognized if they are capable of being sold or licensed independently from other assets of a business.

        (iii) View A3—Change limited to CRIs: Similar to View A2, but limited to CRIs.

        (iv) View A4—Narrower definition of contractual CRIs: Guidance would be narrowed when a CRI meets the contractual and legal criteria for recognition provided in paragraph 805-20-55-25 to exclude ongoing customer relationships associated with purchase-order-based customers or at-will customers.

(b) View B—No change to GAAP: Continue to require recognizing and measuring identifiable intangible assets acquired in a business combination in accordance with Topic 805, Business Combinations.

View A

24. Under View A, intangible assets that are capable of being sold or licensed independently from the other assets of the business (for example, technologies and trade names) would be recognized separately from goodwill. Intangible assets incapable of being sold or licensed independently from a business' other assets would be subsumed into goodwill, which would be recaptioned "goodwill and other intangible assets". Examples of assets that would generally not be recognized separately from goodwill include CRIs and NCAs. In certain industries, CRIs are capable of being sold independently from a business (for example, mortgage servicing rights and banking core deposits), and those particular CRIs would continue to be recognized separately from goodwill under View A. However, other CRIs, including contracts in place, are generally not able to be sold or licensed separately from the business and would, therefore, no longer be recognized separately from goodwill. View A would result in recognition of intangible assets that are actually licensed or sold to third parties as well as intangible assets that are solely used internally but could be sold or licensed to third parties.

25. Some concerns have been raised including the potential for complexity and operational challenges of applying View A in practice, such as how an entity would determine what assets are capable of being sold or licensed independently from the other assets of a business. In response to some of those concerns, the staff considered four views (A1–A4 in paragraph 23 above) that represented different ways to achieve the objective of View A, that is, a reduction in the number of intangible assets recognized separately from goodwill without subsuming all intangible assets into goodwill.

26. Proponents state that View A is consistent with the way an assembled workforce is subsumed into goodwill under current GAAP because it does not meet the "separable or contractual" criterion for asset recognition. Proponents of View A argue that CRIs and NCAs are typically not capable of being sold individually nor can they be licensed to third parties, which makes them incapable of generating cash flows independent from a business. Under View A, the value of assets that cannot be separated from a business or generate independent cash flows would be subsumed into goodwill, similar to assembled workforces under current GAAP.

27. Proponents also argue that while the value of intangibles that can be sold or licensed may be important to some users of financial statements, the value of CRIs and NCAs is disregarded by many users. A qualitative description of those assets (through additional disclosures) may be sufficient for users to understand the nature and importance of those assets. For example, financial statement users may be interested in understanding whether a NCA has been signed, what period it covers, and which parties are covered by the NCA, but the fair value assigned to the NCA under current GAAP is often not as important.

28. Proponents point out that CRIs and NCAs are among the most subjective and difficult intangible assets to value. As a result, View A may result in cost savings to preparers without significantly affecting users. Proponents note that the value of intangible assets that are capable of being sold or licensed, such as technology and trademarks, are relevant to many users, including private company financial statement users. Proponents also note that it would reduce unnecessary cost and complexity on valuing intangible assets whose fair value may have little relevance to some users.

29. Some opponents of View A argue that disclosure of intangible assets often does not provide decision-useful information to users of financial statements. Other opponents argue that, depending on the industry, the value of intangible assets that cannot be sold or otherwise generate cash flows independently from the other assets of a business may still provide decision-useful information to users. Thus, subsuming those intangible assets into goodwill could deprive users of relevant information and impair their ability to evaluate management's capital allocation decisions. In addition, some intangible assets are more relevant to certain industries than others.

30. Some opponents of the overall principle in View A indicated that the definition of what constitutes a CRI may be overly broad under current GAAP, but that the criteria for recognition under View A are too narrow. They noted that fair value information about customer relationships that cannot be sold separately from a business may still be relevant to users, including customer contracts and subscription lists. However, they acknowledged that a case could be made that at-will customer relationships may not warrant recognition, even if an entity does have regular contact with those at-will customers. These proponents would support a broader project that would include reassessing certain intangible asset recognition concepts for all entities and note that there may be a more reasonable middle ground between View A and doing nothing (View B). This concept is included as View A4 in paragraph 23 above.

31. Based on discussions with valuation specialists, the reduction in cost and complexity associated with View A would depend on the facts and circumstances of individual acquisitions. Valuation specialists indicated that, in some cases, View A would result in no intangibles being recognized. For example, for many acquisitions in the service and manufacturing industries, the only intangibles currently recognized are CRIs and NCIs. As such, View A would not necessitate any valuation specialist involvement in those cases for intangible assets (they might still be required for tangible assets). However, in those cases, the cost of the valuation specialist sometimes is not significant in the context of the cost of an acquisition. In other industries, such as technology and consumer products, View A could reduce costs, but would likely still require the use of a valuation specialist for other intangible assets, and so the cost reduction could be insignificant. The valuation specialists interviewed by the staff were unable to indicate how significant the cost reduction would be without all of the other facts and circumstances of an acquisition.

View B

32. Under View B, there is no change to GAAP. An entity would continue to recognize intangible assets acquired in a business combination separately from goodwill on the date of acquisition. Those intangibles may include CRIs, customer contracts, trade names, brands, technology, patents, publishing rights, software, trade secrets, and in-process research and development

(IPR&D). An entity would recognize those intangible assets at their acquisition-date fair values in accordance with Topic 805.

33. Proponents of View B noted that separately recognizing all identifiable intangibles from goodwill is more representationally faithful than allocating all or some intangibles to goodwill, which is consistent with the principle basis for the existing requirement to recognize intangibles separately from goodwill. Proponents acknowledged that the fair value estimates for some intangible assets might require more judgment than other assets. However, they also stated that the financial information that will be provided by recognizing all intangible assets at their fair values is more representationally faithful than that which would be provided if those intangible assets were subsumed into goodwill on the basis of measurement difficulties.

34. Some proponents stated that the "primary" asset, or the asset that is the main reason for the acquisition, should be recognized at fair value. Because primary assets can be intangible assets, they noted that the relevance of financial reporting would be reduced if the model does not require recognition of those assets.

35. Some proponents of View B noted that entities do not incur significant costs associated with the valuation of intangibles recognized in a business combination. They observe that the costs are incurred only on the acquisition date. Those proponents observe that many users do find intangible assets to provide decision-useful information. Proponents also observe that there do not appear to be significant practice issues associated with current GAAP. The staff has not received any technical inquiries related to the issues addressed in this memo in the last three years.

36. The staff notes that while this view leaves the potential for inconsistency between public entities and private companies, it acknowledges the divergent feedback between stakeholders of the two groups.

Appendix A

Summary of the FASB's Past Projects on the Accounting for Identifiable Intangibles in a Business Combination

1. In recent years, the FASB has considered and changed the accounting for identifiable intangible assets in business combinations multiple times.

Accounting for Intangibles before Statement 141

2. Before 2001, Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, provided guidance on accounting for business combinations and allowed business combinations to be accounted for under the purchase method or the pooling of interests method. Intangible assets were recognized at fair value in transactions that were accounted for under the purchase method. If a transaction was accounted for under the pooling of interests method, only those intangible assets previously recorded by the acquired entity could be recognized. In practice, many acquisitions were accounted for under the pooling of interests method and did not result in the recognition of previously unrecognized intangible assets.

3. Under FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, amounts assigned to tangible and intangible assets used in a particular research and development project that have no alternative future use were charged to expense at the acquisition date.

Accounting for Intangibles under Statement 141

4. To address the issue of identifiable intangible assets not being recognized separately from goodwill, the FASB proposed new recognition criteria for identifiable intangible assets in the 1999 Exposure Draft, *Business Combinations and Intangible Assets* (1999 ED). In the 1999 ED, the FASB proposed that intangible assets should be identifiable and reliably measureable to be recognized apart from goodwill. Many respondents disagreed with those

recognition criteria. Respondents to the 1999 ED were opposed to guidance requiring that identifiable intangibles be reliably measurable without defining the parameters of that term.

5. In FASB Statement No. 141, *Business Combinations*, the FASB concluded that for an intangible asset to be separately identifiable and not subsumed into goodwill, it had to meet one of two criteria—the contractual-legal criterion (the asset arose from contractual or other legal rights) or the separability criterion (it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset, or liability). Workforces and acquired research and development assets without an alternate future use were exemptions to this criteria.

6. Statement 141 also eliminated the pooling of interests method so that all business combinations were accounted for under the purchase method. As a result of that change, intangible assets were recognized in most business combinations.

7. Statement 141 retained the previous accounting for research and development and for contingent consideration.

Accounting for Intangibles under Statement 141(R)

8. In 2007, the FASB issued Statement No. 141 (revised 2007), *Business Combinations*, which superseded Statement 141. Statement 141(R) changed the accounting for research and development assets, requiring that their fair value be recognized in a business combination regardless of whether they have any alternative future use. According to Statement 141(R), subsequent to the business combination, assets used in research and development activities were no longer expensed, but were tested for impairment until the completion or abandonment of the research and development project.

9. Statement 141(R) also required acquirers to recognize contingent consideration at the acquisition date at its fair value.

Private Company Council Alternative

10. On February 12, 2013, the Private Company Council (PCC) added an issue to its agenda on accounting for identifiable intangible assets in a business combination in response to feedback from private company stakeholders that indicated that the benefits of the current accounting for identifiable intangible assets acquired in a business combination often do not justify the related costs.

11. On May 7, 2013, the PCC reached a consensus to propose an elective accounting alternative for private companies to account for identifiable intangibles in a business combination when certain criteria are met. The FASB endorsed the decisions by the PCC and, on July 1, 2013, issued proposed Accounting Standards Update, B*usiness Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination*, that described an accounting alternative that would limit the separate recognition to intangible assets with noncancellable contractual terms or other legal rights.

12. After considering feedback from stakeholders, the FASB issued Accounting Standards Update No. 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination*. The PCC and the FASB decided that an entity within the scope of the amendments in that Update could elect not to separately identify and recognize (a) customer-related intangible assets that are not capable of being sold or licensed independently from the other assets of a business and (b) noncompetition agreements. Customer-related intangible assets often will not meet the criterion for recognition. Customer-related intangible assets that may meet the criterion for recognition include mortgage servicing rights, commodity supply contracts, core deposits, and customer information.