October 2, 2019

Technical Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Invitation to Comment: Identifiable Intangible Assets and Subsequent Accounting for Goodwill
(File Reference No. 2019-720)

Dear Technical Director:

Thank you for the public Invitation to Comment: Identifiable Intangible Assets and Subsequent Accounting for Goodwill (File Reference No. 2019-720). We currently are conducting an academic research study that examines how information about identifiable intangible assets acquired in business combinations is reflected in equity market prices. Our study is motivated, in part, by investor feedback provided by the Financial Reporting Council to the IASB in 2014 on similar matters related to accounting for business combinations. We believe that some of the findings from our study may provide useful insights for specific questions contained in Section 2: Whether to Modify the Recognition of Intangible Assets in a Business Combination. More generally, we also believe that our study might inform research by the FASB Staff and the Board’s evaluation of potential accounting alternatives for identifiable intangibles and subsequent accounting for goodwill.

We briefly summarize our study below to provide the context necessary to understand how our findings relate to this Invitation to Comment. We then comment on each of the relevant questions taken from Section 2. Please note that we have also shared this letter and a copy of our study with Christine Botosan (Board member) and Michael Durney (Post-doctoral fellow).

Summary of research findings

1. Relevant investor views on identifiable intangibles acquired in business combinations

Investors assert that the acquisition method of accounting for business combinations results in two accounting problems that limit the usefulness of the information provided under the current financial reporting model (see Financial Reporting Council (FRC) 2014). The first problem that arises is some identifiable intangible assets require future ongoing expenditures to maintain or enhance their value. These expenditures create uncertainty about the amount and timing of future cash flows, and therefore diminish the relation between future cash flows and acquisition date fair values. For instance, investors raise concerns that the value of brands and tradenames depend on ongoing expenditures, such as advertising and promotion, over an indefinite and uncertain horizon. Moreover, investors have difficulty identifying and disentangling the future cash flows related to the intangible asset acquired on the acquisition date and the additional post-acquisition expenditures incurred to maintain or enhance its value. Investors refer to intangible assets that require ongoing expenditures to maintain or enhance their value as organically replaced (FRC 2014).
Other intangible assets have identifiable revenue streams that do not require future investment and often have definite lives that are legally or contractually determined. Compared to organically replaced intangibles, there is less uncertainty about the amount and timing of future cash flows associated with these assets, including those related to future revenue streams. For example, a patented pharmaceutical has a legally defined limit to the period over which a firm has an exclusive right to sell that pharmaceutical technology. In addition, revenues that arise from the sale of a patented pharmaceutical can be separately identified from other cash flows, and prior to patent expiration, do not require additional investment. Investors refer to intangible assets with identifiable revenue streams that do not require future investment often with legally or contractually determined useful lives, as wasting intangible assets. Therefore, investors claim that acquisition date fair values of wasting intangibles are more decision useful than organically replaced intangibles.

The second accounting problem arises from application of the identifiability criterion under ASC 805. One objective of the identifiability criterion in SFAS 141R was to reduce the magnitude of goodwill balances and increase the amount of information available to investors about the nature of identifiable intangible assets acquired in business combinations. Intangible assets acquired in a business combination are identifiable if they are either (1) separable from the entity (i.e., could be sold, licensed, rented, exchanged, or transferred to a third party) or (2) arise from contractual/legally enforceable rights. Therefore, the current financial reporting model sometimes requires recognition of assets that are not of strategic importance, which is of limited informational use to investors. We also posit that the identifiability criterion can result in recognition of intangibles that do not meet the definition of an asset in the Conceptual Framework because the definition does not consider whether an item is separable from the entity.

The Conceptual Framework defines an asset in terms of three primary attributes: (1) probable future economic benefit (2) obtained or controlled by the entity by excluding others’ access to the benefit and (3) the benefit is the result of past transactions or events. Consider a customer relationship asset recognized in a business combination comprised of customers’ personal information that enables a firm to generate repeat sales in the future and that the customer information can be sold separately. There is clearly a probable economic benefit related to future sales; however, it is not clear whether the entity can exclude others’ access to the benefits even though the personal information can be sold separately.

2. Empirical analysis and findings

We empirically evaluate investors’ assertions about the decision usefulness of wasting, organically replaced, and strategically important intangibles. Our analysis utilizes a proprietary dataset containing information on acquiring firms’ acquisition date fair value estimates of identifiable intangibles reported by public U.S. firms. To our knowledge, this dataset is the most comprehensive source of data on acquired intangible assets, comprised of more than 3,500 M&A transactions completed between 2009 and 2016. From this dataset, we are able to link 2,980 deals to financial statement and stock price information for 1,547 unique U.S. firms. On average, total assets acquired within the sample of deals is about $1.1 billion with 31% of total assets acquired classified as identifiable intangibles. On an aggregate basis, the sample represents approximately $3.2 trillion of U.S. M&A activity resulting in the addition of more than $670 billion in identifiable intangible assets to firms’ balance sheets. These data allow us to make inferences about an economically significant sample of identifiable intangible assets recognized in firms’ financial statements over the last 10 years.
Our research design follows prior studies from the value relevance literature that examine the association of stock prices with earnings and book values. Following this line of research, we use stock prices as a summary measure of investors’ consensus beliefs about the amount, timing, and uncertainty of future cash flows to the firm. In our setting, this research design provides a framework to test whether identifiable intangibles reported in firms’ purchase price allocation disclosures are relevant and faithful representations of investors’ consensus beliefs about the amount, timing, and uncertainty of future cash flows expected from those assets. We also are able to draw inferences about differences in investors’ consensus beliefs and the information reflected across different types of identifiable intangibles reported in firms’ purchase price allocation disclosures.

Our first set of hypotheses assesses the value relevance of wasting and organically replaced identifiable intangible assets. First, because fair value provides an estimate of the discounted future cash flows to the entity from both wasting and organically replaced intangible assets acquired in a business combination, we predict that both wasting and organically replaced identifiable intangible assets have a positive association with equity prices. Second, we predict that wasting identifiable intangible assets have a more positive association with equity prices than organically replaced identifiable intangible assets. This prediction follows from the idea that information reported for wasting intangibles is a more relevant and faithful representation of the future cash flows to an entity, related to that asset, than it is for organically replaced identifiable intangible assets. This arises because the fair value estimate more completely reflects the totality of expected future cash flows from a wasting asset that does not require additional expenditures to maintain or enhance its value. Similar to organically replaced intangibles, goodwill also lacks an identifiable cash flow stream and requires continuing investments to integrate the firms’ operations and realize expected synergies. Therefore, we predict that organically replaced intangibles and goodwill will exhibit similar associations with post-acquisition equity values.

We define organically replaced intangibles as those that require ongoing investment to maintain or enhance their value. Therefore, we classify customer-related intangibles, trademarks, and tradenames, as organically replaced intangibles because the value of these assets depends on future expenditures (e.g., promotion and marketing). We also classify in-process R&D as an organically replaced intangible due to the ongoing nature of the underlying R&D activities related to these assets. We classify the remaining types of identifiable intangibles in our sample as wasting, which mostly consists of developed technologies (e.g., patents) and contract-related intangibles. These assets have identifiable revenue streams that do not require significant ongoing investments to maintain or enhance their cash flow generating ability. Our results provide support for our predictions. We find that both wasting and organically replaced intangible assets exhibit positive and significant associations with post-acquisition equity values. However, we find that the association for organically replaced intangibles is less positive than wasting intangibles, consistent with differences in the usefulness of information reflected in investors’ consensus beliefs across these types of intangibles. In addition, we also find no difference in the associations between equity prices with organically replaced intangibles and goodwill.

Our second set of hypotheses assesses the value relevance of strategically important versus other identifiable intangible assets. Again, we predict that both strategically important and other identifiable intangible assets have positive associations with equity prices because fair value provides an estimate of the discounted future cash flows to the entity from both of these types of identifiable intangible assets.

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However, we predict that the most strategically important identifiable intangible assets have stronger associations with equity prices than other identifiable intangible assets. This hypothesis follows from the idea that the identifiability criterion potentially requires firms to recognize assets that are of little strategic importance.

Considering the definition of an asset in the FASB Conceptual Framework, we focus on the likelihood that an identifiable intangible asset is a primary source of future economic benefit in a given deal. We use multiple methods to classify identifiable intangibles as strategically important, based on the underlying assumption that identifiable intangible assets representing key value-drivers for the acquisition likely account for a relatively large percentage of total assets acquired. Our classification approach also allows us to capture variation across firms and industries among the types of intangibles that are most likely to be strategically important. For example, our classification methodology most frequently classifies developed technologies and in-process R&D as strategically important in high-tech and pharmaceutical industries, whereas customer-related intangibles are classified most often as strategically important in service industries (e.g., entertainment, telecommunications, insurance).

Our tests show a positive and statistically significant association between strategically important intangibles and post-acquisition equity prices. In contrast, we find no association between other identifiable intangible assets and equity prices. These results are consistent with investors’ claims that financial reporting information about identifiable intangibles is relevant when the asset is related to the strategic objectives for the acquisition, but that information for other intangibles is not relevant.

Our final set of tests build on our findings related to investors’ consensus beliefs reflected in equity prices about wasting, organically replaced, and strategically important intangibles. We conduct cross-sectional tests by partitioning wasting and organically replaced intangibles within the strategic importance classifications. In this analysis, we find that only strategically important identifiable intangible assets are positively associated with post-acquisition equity prices. Within the cross-section of strategically important identifiable intangible assets, organically replaced intangible assets also exhibit a less positive association with equity prices than wasting intangible assets. Neither wasting nor organically replaced intangibles are associated with equity prices when these assets are not strategically important.

3. **Key takeaways relevant to standard-setting**

Our findings provide evidence that the value relevance of identifiable intangible assets differs predictably with economic characteristics related to those assets, and that identifiable intangible assets acquired in business combinations are not value relevant when they are not strategically important. Prior academic research has criticized the current accounting model for identifiable intangible assets for not recognizing in the balance sheet all intangible assets, especially internally developed intangibles. Our findings suggest that not all capitalized intangibles provide a relevant and faithful representation of the future cash flows used by investors in security pricing. This provides evidence that capitalization of intangibles may not offer the panacea that prior research has suggested. In addition, our findings suggest that standard setters may consider alternative means to augment or replace the capitalization of intangible assets to provide decision-useful information to investors that better meet the objective of financial reporting.
Responses to questions from the invitation to comment

13. Please describe what, if any, cost savings would be achieved if certain recognized intangible assets (for example, noncompete agreements or certain customer-related intangible assets) were subsumed into goodwill and amortized. Please be as specific as possible. For example, include specific purchase price allocation or subsequent accounting cost savings. Please list any additional intangible items the Board should consider subsuming into goodwill.

Our empirical analyses did not separately analyze non-compete agreements or distinguish between certain types of customer-related intangibles. However, we would reasonably assume that potential cost savings could be achieved if the acquirer could forgo obtaining third party valuations to support estimates of acquisition date fair values. Similarly, subsuming these assets into goodwill could produce cost savings related to third party valuations for subsequent impairment testing of non-competes and customer-related intangibles. Our findings suggest that there is little benefit from recognizing non-strategically important intangibles assets, which might support subsuming these intangibles into goodwill. However, we do not see a reasonable way in which this concept could be implemented consistently in accounting standards. Furthermore, commingling non-strategically important intangible assets with goodwill has the potential to reduce the decision usefulness of goodwill. Therefore, we conclude that the findings of our study do not provide strong support for subsuming additional intangible items into goodwill.

14. Please describe what, if any, decision-useful information would be lost if certain recognized intangible assets (for example, noncompete agreements or certain customer-related intangible assets, or other items) were subsumed into goodwill and amortized. Please be as specific as possible. For example, include specific analyses you perform that no longer would be possible.

The data we obtained on identifiable intangibles is aggregated into five separate categories. One category captures all customer-related intangibles (customer lists, customer relationships, etc.). To the best of our knowledge, non-compete agreements are aggregated within “Other intangibles,” which are primarily contract-related intangibles. In our study, we considered customer-related intangibles as “organically replaced”, and non-compete agreements as “wasting” intangibles. Customer-related intangibles are often identified as strategically important within many service industries (e.g., entertainment, telecommunications, insurance).

We believe that the results of our study suggest that financial statement users could lose important information about the underlying composition of the assets acquired in a business combination if some identifiable intangible assets were subsumed in goodwill. In some cases, users would lose information about key value drivers in certain M&A transactions. Specifically, our findings suggest that information about strategically important intangibles is reflected in post-acquisition equity values. We interpret this result consistent with acquisition date fair values, in combination with additional financial statement disclosures, providing information that is both a relevant and faithful representation of the amount and timing of future cash flow realizations expected from these assets.

Subsuming identifiable intangibles into goodwill is not a faithful representation of the business combination because identifiable intangibles have fundamentally different economic features that are dissimilar to goodwill. For example, these differences arise from features such as separability, patterns of future benefit, and useful lives, which also have important implications for subsequent accounting. By subsuming...
additional identifiable assets into goodwill, this alternative would likely reduce the decision usefulness of acquired goodwill in investors’ analysis of business combinations.

15. How reliable is the measurement of certain recognized intangible assets (for example, noncompete agreements or certain customer-related intangible assets)?

The analyses that we conduct are well-established joint tests of relevance and faithful representation. We find robust positive and significant associations between identifiable intangible assets and post-acquisition equity prices. This suggests that identifiable intangibles are both relevant to investors, and sufficiently reliable to produce statistically significant associations with equity prices. However, our results also show that the association between equity market values and organically replaced intangibles is less positive than the association for wasting intangibles, and that this pattern is concentrated within strategically important intangibles. Assuming equal relevance across all strategically important intangibles, we interpret these results as evidence that organically replaced intangibles (which include customer-related intangibles) are less reliably measured than wasting intangibles (which include non-compete agreements). Our results also can be interpreted as evidence that investors do not find information about non-strategically important intangibles to be highly relevant.

17. Of the possible approaches presented, which would you support on a cost-benefit basis? Please rank the approaches (1 representing your most preferable approach) and explain why you may not have selected certain approaches.

- Approach 1: Extend the Private Company Alternative to Subsume Certain CRIIs and all NCAs into Goodwill
- Approach 2: Apply a Principles-Based Criterion for Intangible Assets
- Approach 3: Subsume All Intangible Assets into Goodwill
- Approach 4: Do Not Amend the Existing Guidance.

Of these possible approaches, Approaches 2 and 4 have the most support from a cost-benefit perspective. With respect to Approach 4, our findings suggest that financial statement users obtain and process important information about underlying differences in the economic characteristics of identifiable intangibles. Investors emphasize the importance of disclosures about assets that are key value drivers in M&A transactions, and how those assets relate to important aspects of the business acquired.

A “principles-based” criteria based on the essential characteristics of assets from CON 6 has some conceptual appeal, and would also reduce costs for some preparers for reasons such as those we discuss above in our response to question 13. However, this alternative comes with the potential for information loss if identifiable intangibles reported under the current guidance are subsumed into goodwill, especially when those assets are strategically important value drivers. Again, we emphasize that our research does not examine costs, nor does it quantify informational benefits. However, our findings lend support to the conclusion that investors find recognized intangibles to be decision useful, and we believe that additional qualitative disclosures about the strategic importance of the asset can provide an important information source that enhances decision usefulness even in situations in which there may be some question about whether certain identifiable intangibles have the essential characteristics of an asset.

18. As it relates to Approach 2 (a principles-based criterion), please comment on the operability of recognizing intangible assets based, in part, on assessing whether they meet the asset definition.
One criticism of the current accounting model for business combinations is that the separability and contractual/legal criterion do not have a conceptual basis that comports with the essential characteristics of assets in CON 6. As a result, application of these criterion to distinguish between identifiable and unidentifiable assets can result in recognition of assets that do not meet the conceptual definition of an asset. We discuss in our research examples of customer relationship assets recognized in business combinations comprised of customers’ personal information that enables a firm to generate repeat sales in the future. There is clearly a probable economic benefit related to future sales; however, it is not clear whether the entity can exclude others’ access to the benefits even if the personal information can be sold separately. Therefore, application of the assets definition to assets such as customer-related intangibles could be operable.

19. Approaches 1–3 assume that subsuming additional items into goodwill would necessitate the amortization of goodwill. Do you agree or disagree? Please explain why.

We do not agree that subsuming additional items into goodwill necessitates goodwill amortization. This would impose a uniform amortization period on the goodwill balance, but that balance aggregates different underlying assets with different patterns of benefit. Therefore, amortization of goodwill under these approaches would not be a faithful representation of diminution of value or allocation of cost to future periods. Instead, we believe that separate recognition of, and subsequent accounting for, identifiable intangibles (based on the criteria set forth in the current guidance) provides more decision useful information.

We would be happy to answer any questions you might have or discuss these matters further at any time.

Sincerely,

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