FASB Emerging Issues Task Force

Issue No. 04-1

Title: Accounting for Preexisting Relationships between the Parties to a Business Combination

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FASB Staff: Munro (ext. 350)/McBride (ext. 384)

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References:

FASB Statement No. 5, *Accounting for Contingencies* (FAS 5)

FASB Statement No. 45, *Accounting for Franchise Fee Revenue* (FAS 45)

FASB Statement No. 141, *Business Combinations* (FAS 141)

FASB Statement No. 142, *Goodwill and Other Intangible Assets* (FAS 142)

APB Opinion No. 26, *Early Extinguishment of Debt* (APB 26)

AICPA Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (ARB 43)

EITF Issue No. 02-17, "Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination" (Issue 02-17)

EITF Abstracts, Topic No. D-100, "Clarification of Paragraph 61(b) of FASB Statement No. 141 and Paragraph 49(b) of FASB Statement No. 142" (Topic D-100)

* **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination and it is ratified by the Board.**

Background

1. This Issue was originally referred by the EITF Agenda Committee to the FASB's project team on Business Combinations: Purchase Method Procedures. Since the FASB's joint project with the IASB on Purchase Method Procedures is not expected to specifically address all aspects of this Issue in the near term, it was added to the EITF agenda.

2. This Issue applies when two parties that have a preexisting relationship enter into a business combination. Specifically, the Issue is whether a consummation of a business combination between two parties that have a preexisting relationship should be evaluated to determine if a settlement of a preexisting relationship exists, and the accounting for the preexisting relationship.

Previous Discussion

3. At the March 17–18, 2004 EITF meeting, the Task Force reached a tentative conclusion that consummation of a business combination between two parties that have a preexisting relationship should be evaluated to determine whether a settlement of a preexisting relationship exists. In reaching its tentative conclusion, the Task Force observed that a business combination between two parties that have a preexisting relationship could be viewed as a multi-element transaction with one element being the business combination and the other element being the settlement of the preexisting relationship.

4. The Task Force also discussed alternative views on the measurement and recognition of a settlement of the preexisting relationship but was not asked to reach a consensus. The Task Force directed the FASB staff to further explore alternative views on the measurement and recognition of the settlement of the preexisting relationship.

5. At the June 30–July 1, 2004 EITF meeting (June-July Meeting), the Task Force discussed the following model that was proposed by the FASB staff to address the measurement and recognition of the settlement of the preexisting relationship. The model reflects two general principles: (a) the measurement and recognition of the identifiable assets and liabilities of the acquired entity should be based on fair value (a marketplace participant view) and (b) the

accounting for the settlement of the preexisting relationship generally should be the same whether within a business combination or absent a business combination.

<u>Step 1</u>: Allocate the cost of the acquired entity to the identifiable assets acquired and liabilities assumed (including any identifiable assets and liabilities of the acquired entity related to the preexisting relationship) based on their estimated fair values at the date of the acquisition with any residual recognized as goodwill in accordance with FAS 141.

<u>Step 2:</u> Segregate the identifiable assets and liabilities related to the preexisting relationship.

<u>Step 3:</u> For each asset (liability) identified in Step 2, determine how the amount allocated to each asset (liability) in Step 1 would be recognized had that amount been paid (incurred) absent the business combination.

6. The Task Force discussed the model and directed the FASB staff to further explore alternative views for the measurement and recognition of the settlement of a preexisting relationship in a business combination.

Current Discussion

7. This Supplement addresses the measurement and recognition of a settlement of a preexisting relationship in conjunction with a business combination and whether certain reacquired rights should be recognized as intangible assets apart from goodwill. While exploring alternative views on the measurement and recognition of a settlement of a preexisting relationship, the FASB staff analyzed the Task Force's previous discussions regarding various types of settlements, including (a) debt settlements, (b) settlements of lawsuits, and (c) settlements of executory contracts such as basic supply contracts or licensing agreements such as franchise or technology agreements.[1]

8. For the effective settlement of debt in a business combination, the Task Force generally agreed on measurement and recognition. That is, if the acquired entity has an investment in debt securities of the acquirer with a fair value of $110 and the carrying amount of the acquirer's debt is $100, the acquirer would recognize a settlement loss of $10. The FASB staff observes that this conclusion is consistent with APB 26 and believes that APB 26 should be applied to the

[1] Any consensuses in this Issue would apply to the consolidated financial statements of the acquirer. This Issue Summary Supplement does not address the accounting for the preexisting relationship in the standalone financial statements of the acquired entity.

effective settlement of the acquirer's debt in a business combination. APB 26 states that when debt is settled (extinguished) prior to maturity, the amount paid upon reacquisition of debt securities may differ from the net carrying amount of the debt at that time. Paragraph 20 of APB 26 states that that difference should be recognized in income in the period of the extinguishment as losses or gains. The application of the guidance in APB 26 to the effective settlement of the acquirer's debt in a business combination would result in the settlement being measured at the difference between the reacquisition price (either fair value or stated settlement amount, if different) and the carrying amount of the debt.[2]

9. For settlements of lawsuits, the FASB staff observes that the Task Force also generally agreed on measurement—that is, the settlement amount would be equal to the difference between the fair value of the acquired entity's contingent asset (liability) and the carrying amount of the acquirer's contingent liability (asset). Further, the Task Force generally agreed that if the measured settlement amount results in a settlement loss, that amount should be recognized as a loss in the acquirer's consolidated statement of operations. For example, if the acquired entity has a contingent asset (likely unrecognized) related to a lawsuit with the acquirer that has a fair value of $75 and the acquirer has accrued a related liability under FAS 5 with a carrying amount of $50, the acquirer would recognize a settlement loss of $25. However, if the acquired entity has a contingent liability related to a lawsuit with the acquirer that has a fair value of $50 and the acquirer has not recognized a contingent asset (carrying amount is $0), it is less clear whether the Task Force agreed that the acquirer should recognize a settlement gain of $50.

10. In contrast, for settlements of executory contracts, the Task Force appeared to have differing views on the appropriate measurement of the settlement and whether the measured settlement amount should be recognized in the statement of operations. The Task Force generally agreed that the acquirer should recognize a settlement loss if the acquired entity has a supply arrangement with the acquirer that has terms that are unfavorable (compared to market) to the acquirer, but the Task Force appeared to be split on whether a settlement gain could be recognized. Accordingly, this Supplement first focuses on settlements of executory contracts by

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[2] The FASB staff observes that if the acquirer is holding the debt of the acquired entity, APB 26 would not apply to the acquirer.

separately addressing a settlement of an executory contract (basic supply contract) and a settlement of an arrangement in which, prior to the acquisition, the acquirer had granted certain rights to the target entity that are now being reacquired.

11. When addressing measurement, the objective is to measure the amount of the settlement activity.[3] However, because the Task Force has expressed divergent views as to whether a settlement gain should be recognized in conjunction with a business combination, this Issue Summary specifically addresses when, if ever, a settlement gain should be recognized.

12. This Issue Summary also addresses the classification of certain assets of the acquired entity that the Task Force concludes should be accounted for as part of the business combination rather than the settlement. Finally, this Issue Summary considers transition alternatives.

13. The ultimate objective of this Supplement is to assist the Task Force in building a model for accounting for a preexisting relationship between parties to a business combination. To achieve that objective, different types of relationships are considered individually to enable the Task Force to evaluate whether the development of a single model for all settlements can be achieved.

Accounting Issues and Alternatives

Measurement—Executory Contracts

14. This section addresses how to measure the settlement amount for the effective settlement of an executory contract in a business combination and assumes that the executory contract is a basic supply arrangement. At the acquisition date, the arrangement may have "favorable," "unfavorable," or "at-market" pricing terms. In this Supplement, favorable and unfavorable pricing terms are consistently discussed from the perspective of the **acquirer** in a business

[3] The amount ultimately recognized as a settlement loss (gain) in the acquirer's consolidated statement of operations may differ from the amount measured in cases in which the acquirer had previously accrued a loss related to the contractual relationship pursuant to applicable authoritative guidance (for example, the acquirer was required to accrue a loss under a firm purchase commitment for inventory, pursuant to the provisions in ARB 43 (Chapter 4, Statement 10). A loss accrual would affect the amount ultimately recognized as a settlement loss in the consolidated statement of operations. In addition, if the acquirer had previously recognized a loss that exceeded the settlement loss measured, the excess may result in a settlement gain.

combination. Therefore, the phrase "unfavorable contract" means that the contract's terms are unfavorable to the acquirer when compared to pricing for current market transactions for the same or similar items, and the phrase "favorable contract" means that the contract's terms are favorable to the acquirer when compared to pricing for current market transactions for the same or similar items. An unfavorable contract is not necessarily a loss contract for the acquirer and, therefore, the acquirer may not have recognized a liability prior to the business combination.[4]

15. The model that the Task Force discussed at the June-July Meeting would have required the settlement to be measured at fair value. However, a number of Task Force members questioned whether fair value measurement would be appropriate if the terms of a contractual relationship provided specific settlement terms or the contract was cancelable by the acquirer without penalty. In addition, some Task Force members discussed whether the effective settlement of a contract with at-market terms should result in a settlement charge. In other words, they questioned whether the measurement of the settlement should include the fair value of the at-market component of the contract (that component would include, for example, the selling effort).

16. The FASB staff suggests that when considering the alternative views for Issue 1, the Task Force should consider the following example in which the acquirer purchases its supplier in a business combination and that supplier's preexisting supply contract has pricing terms unfavorable to the acquirer at the date of the business combination:

> **Example 1**
> Company X purchases electronic components from Company Y under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than rates at which Company X could purchase similar electronic components from another supplier. The supply contract includes provisions that Company X can only terminate the contract prior to the end of the initial 5-year term by paying a $6 million penalty. With 3 years remaining under the supply contract, Company X pays $50 million (net of liabilities assumed) to acquire Company Y (fair value of Company Y based on what marketplace participants would be willing to pay).

[4] The FASB staff observes that even if the acquirer has a loss contract, the acquirer may not have accrued a liability unless permitted under generally accepted accounting principles.

Assume that included in the total fair value of Company Y is $8 million related to the fair value of the supply contract with Company X. Further, assume that the $8 million can be further bifurcated into a $3 million "at-market" component (selling effort, customer relationships, and so forth) and a $5 million "off-market" component (pricing is favorable to Company Y). Also assume, for simplicity, that Company Y has no other identifiable assets or liabilities related to the supply contract and that Company X has not recognized any assets or liabilities related to the supply contract prior to the business combination.

Issue 1: How the settlement amount for an executory contract should be measured.[5]

View A: The settlement amount should be measured at the fair value of *<u>all</u>* *of the acquired entity's identifiable net assets (liabilities) associated with the preexisting relationship.*

17. View A proponents believe that the settlement of an executory contract should be measured at the value that the acquired entity would lose (gain) as a direct result of terminating the preexisting relationship. View A proponents believe that the amount would be the fair value of all of the acquired entity's identifiable net assets (liabilities) associated with the preexisting relationship—that is, the amount a third party (marketplace participant) would pay to acquire the assets and assume the liabilities associated with the executory contract. View A proponents acknowledge that a contract may have stated termination provisions and that the two parties may have negotiated a lesser amount. However, View A proponents observe that when measuring the fair value of the acquired entity's net assets (liabilities) associated with the contractual relationship in a business combination, that measurement would consider factors including, but not limited to, (a) stated termination provisions, (b) pricing terms in comparison to comparable market transactions, (c) the ability of either party to terminate the contract considering the availability of replacement products, services, or customers, (d) expectations of renewal, and (e) other benefits (customer relationships). In the above example, View A proponents believe that the settlement amount would be an $8 million loss.

[5] Refer to footnote 3.

View B: The settlement amount should be measured at the lesser of (a) the fair value of all of the acquired entity's identifiable net assets (liabilities) associated with the preexisting relationship or (b) any stated settlement provisions in the contract.

18. View B proponents believe that the settlement amount should be measured at the amount that the acquirer would have to pay to terminate the preexisting relationship absent a business combination. Absent any stated settlement provisions in the contract, View B proponents agree with View A proponents that the settlement amount should be measured at the fair value of the acquired entity's net assets (liabilities) associated with the preexisting relationship (in the above example, the settlement amount would be an $8 million loss). However, View B proponents note that contractual-based relationships may contain explicit settlement provisions and that, in those cases, the party choosing to settle the relationship would pay the lesser of the stated settlement provisions or the fair value of the counterparty's net assets associated with the contract. Therefore, View B proponents believe that the settlement amount should be measured at the lesser of (a) the fair value of all of the acquired entity's identifiable net assets (liabilities) associated with the preexisting relationship or (b) any stated settlement provisions in the contract if the acquirer (acquired entity) has a contractual termination right that could limit the settlement amount when determining a settlement loss (gain). If the contract was cancelable at the acquirer's option without a termination penalty, View B proponents believe the settlement amount would be $0. In the above example, View B proponents believe that the settlement amount would be a $6 million loss.

19. View B proponents observe that to the extent the settlement amount is less than the fair value of all of the acquired entity's identifiable net assets (liabilities) associated with the preexisting relationship due to stated settlement provisions, the difference would be included as part of the accounting for the business combination.

View C: The settlement amount should be measured at only the amount by which the contract is favorable or unfavorable to market.

20. View C proponents believe that a deemed settlement of a preexisting relationship between parties to a business combination is a different economic event than if the parties settled the relationship absent a business combination. View C proponents observe that a settlement absent a business combination results in the parties terminating their relationship. In contrast, there may be elements of the preexisting relationship that continue to benefit the combined entity in a business combination. Therefore, View C proponents believe that a deemed settlement between parties to a business combination with a preexisting relationship results from combining the two entities (consolidation) rather than from the entities terminating their relationship.

21. View C proponents observe that a contractual relationship may have two separate value components: (a) the value associated with terms that are either favorable or unfavorable as compared to market (hereinafter referred to as the "off-market" component) and (b) the value associated with the contract in place (selling effort, customer relationships, and so forth) (hereinafter referred to as the "at-market" component). View C proponents believe that only the off-market component of the arrangement should be accounted for as a settlement because that component clearly does not represent future benefits or obligations of the combined entity. For example, if the acquired entity has an asset related to an unfavorable contract with a fair value of $100, the acquirer has an unrecognized corresponding liability (not necessarily recognized due to a loss contract) with a fair value of $100. In consolidation, the benefits and obligations associated with that asset and that liability would cease to exist from the perspective of the combined entity. View C proponents note that to the extent that the acquirer had recognized a corresponding asset or liability related to the off-market terms of the contract, the settlement amount would be measured at the difference between the acquired entity's fair value and the acquirer's carrying amount. In the above example, View C proponents believe that the settlement amount would be a $5 million loss.

22. In a business combination, View C proponents believe the "at-market" component of a contract is indistinguishable from the other expected value and synergies of the business combination and, therefore, should be included as part of the business combination rather than as part of the settlement.

View D: The settlement amount should be measured at the lesser of (a) the amount by which the contract is favorable or unfavorable to market or (b) any stated settlement provisions in the contract.

23. View D proponents agree with View C proponents except that like View B proponents, View D proponents believe that the settlement amount should never exceed any stated settlement provisions. Therefore, View D proponents believe that the settlement amount should be measured at the lesser of (a) the amount by which the contract is favorable or unfavorable to market and (b) any stated settlement provisions in the contract if the acquirer (acquired entity) has a contractual termination right that could limit the settlement amount when determining a settlement loss (gain). In the above example, because the stated settlement amount is greater than the amount by which the contract is favorable to the acquired entity, View D proponents believe that the settlement amount would be measured at a $5 million loss. However, if the stated settlement amount was less than $5 million, View D proponents believe that the settlement would be measured at that lesser amount.

24. View D proponents observe that to the extent the stated settlement amount is less than the off-market component of the acquired entity's identifiable net assets (liabilities) associated with the preexisting relationship, the difference would be included as part of the consideration for the business combination.

25. In a business combination, View D proponents believe the "at-market" component of a contract is indistinguishable from the other expected value and synergies of the business combination and, therefore, should be included as part of the business combination rather than as part of the settlement.

Measurement—Reacquired Rights

26. This section addresses how to measure the settlement amount for contractual relationships in which, prior to the business combination, the acquirer had granted the acquired entity certain contractual rights to the acquirer's existing recognized or unrecognized intangible assets (for example, rights to the acquirer's trade name under a franchise agreement or rights to the

acquirer's technology under a technology licensing agreement). At the acquisition date, the terms of these arrangements (for example, royalty rates) may be either favorable or unfavorable to market terms or at market terms. When parties to a business combination have this type of preexisting relationship, some believe that, in addition to settling the relationship, the acquirer is reacquiring the right previously granted. The FASB staff observes that these arrangements may also include a basic supply arrangement but when deliberating the issues in this section, the Task Force should assume there is no supply element in the arrangement as those situations were addressed in the previous section. Therefore, this section focuses solely on the accounting for the reacquisition of the right previously granted by the acquirer—specifically, whether the reacquired right should be included in the measurement of the settlement amount or included as part of the business combination.

27. The FASB staff suggests that when considering the alternative views for Issue 2, the Task Force should consider the following example in which the acquirer previously granted a franchisee exclusive rights to its trade name and other intangible assets in a specified territory and then subsequently acquires the franchisee's business. However, the alternative views for Issue 2 also would be applicable to the reacquisition of other types of rights such as technology or distribution rights. In the following example, assume that no factors exist that would call into question the original accounting for the sale of the franchise and that the transaction is not, in substance, a cancellation of the original franchise sale pursuant to paragraph 19 of FAS 45.[6]

> **Example 2**
> Fast Food Company X acquired the business of its operating franchisee, Franchise A. Fast Food Company X pays $100 million (net of liabilities assumed) to acquire Franchise A (fair value of Franchise A based on what marketplace participants would be willing to pay).
>
> Assume that included in the total fair value of Franchise A is an intangible asset with a fair value of $40 million related to the exclusive rights granted to Franchise A by Company X to use its trade name and other intangible assets in a specified territory. Assume that the terms of the franchise agreement are at market rates and that the franchise agreement states that if Company X terminates the arrangement without cause, Company X will be required to pay a $38 million termination penalty to Franchise A.

[6] Similar factors would need to be considered when other types of rights are reacquired (that is, a consistent pattern of reacquiring rights previously granted could question the validity of the original sales accounting).

Also assume, for simplicity, that Franchise A has no other identifiable assets or liabilities related to the franchise agreement and that Company X has not recognized any assets or liabilities related to the franchise agreement.

Issue 2: Whether the acquisition of a right that the acquirer had previously granted to the acquired entity to use the acquirer's existing recognized or unrecognized intangible assets should be included in the measurement of the settlement amount or included as part of the business combination.

View A: The reacquired right should be included in the measurement of the settlement amount.

28. View A proponents believe that the settlement of an executory contract should be measured at the value that the acquired entity would lose (gain) as a direct result of terminating the preexisting relationship, which would include the fair value of the reacquired right. Therefore, View A proponents believe that the fair value of the reacquired right should be included in the measurement of the settlement amount (View A for Issue 1). In the above example, the settlement amount would be a $40 million loss.

View B: The reacquired right should be included in the measurement of the settlement amount; however, the settlement amount should never exceed any stated settlement provisions in the contract.

29. View B proponents believe that the settlement amount should be measured at the amount that the acquirer would have to pay to terminate the preexisting relationship absent a business combination. Absent any stated settlement provisions in the contract, View B proponents agree with View A proponents that the settlement amount should include the fair value of the reacquired right. However, View B proponents believe that the settlement amount should not exceed any stated settlement provisions (View B for Issue 1) if the acquirer (acquired entity) has a contractual termination right that could limit the settlement amount when determining a settlement loss (gain). In the above example, View B proponents believe that the settlement amount would be a $38 million loss.

View C: The reacquired right should be included as part of the business combination.

30. View C proponents believe that the settlement gain or loss on the effective termination of a contract in a business combination should not include the value attributed to a reacquired right and, therefore, that value should be included as part of the business combination. Effectively, the amount paid to reacquire rights previously granted by the acquirer is the acquisition of an asset because it provides future benefit to the combined entity (that is, the combined entity will receive incremental future cash flows associated with the reacquired right). In the above example, the $40 million paid for the reacquired right would be included as part of the business combination. View C proponents observe that, in the above example, the terms of the franchise agreement were at market rates. However, if the franchise agreement included terms that were "off market," View C proponents believe that the value of the franchise agreement attributable to the off-market terms would be included in the measurement of the settlement amount. The issue of whether the reacquired right should be recognized as an intangible asset or subsumed into goodwill is addressed under "Classification" below.

Measurement—Lawsuits

31. The Task Force previously agreed that the settlement of a lawsuit should be measured at fair value. Considering the alternatives for measurement in Issue 1 (executory contracts), the FASB staff believes that the Task Force has reached the only viable alternative for settlement of lawsuits—fair value. That is, lawsuits are not subject to contractual termination provisions or terms that are above or below market. Accordingly, the only viable alternative is fair value. The next section addresses whether the acquirer should recognize a gain for the effective settlement of a lawsuit in conjunction with a business combination.

Gain Recognition

32. While the Task Force appears to be in general agreement that a settlement loss should be recognized for the effective settlement of a lawsuit or an executory contract in a business combination, the Task Force has expressed divergent views as to whether a settlement gain should be recognized.

33. The FASB staff is not aware of any reasons for the Task Force to reach different conclusions on whether gain recognition is appropriate for effective settlements of lawsuits and executory contracts. Therefore, this section addresses whether a settlement gain should be recognized in the acquirer's consolidated statement of operations for the effective settlement of both a lawsuit and an executory contract in a business combination.

Issue 3: Whether an acquirer should recognize a settlement gain in conjunction with the effective settlement of a lawsuit or an executory contract in a business combination.

View A: An acquirer should recognize a settlement gain.

34. Proponents of View A believe that there should be symmetry in the accounting for settlements. View A proponents argue that if a lawsuit or an executory contract is settled absent a business combination, it could result in the recognition of either a settlement gain or a settlement loss and that the accounting should not be different if the effective settlement occurs in conjunction with a business combination.

View B: An acquirer should not recognize a settlement gain.

35. View B proponents do not believe that the acquirer should recognize a settlement gain for the effective settlement of a lawsuit or an executory contract in conjunction with a business combination because of the difficulty in measuring the settlement gain. The measurement difficulty can arise from either the settlement gain being inseparable from the other synergies and benefits of the business combination or the measurement requiring significant non-market inputs. Accordingly, any settlement gain would be recognized as part of the business combination—that is, effectively subsumed in goodwill.

View C: An acquirer should recognize a settlement gain only if the acquirer had accrued a loss or recognized a liability associated with the preexisting relationship prior to the business combination.

36. View C proponents believe that recognition of a settlement gain should only be permitted when the acquirer had previously accrued a loss or recognized a liability associated with the preexisting relationship prior to the business combination and the settlement loss (measured in Issue 1 and Issue 2) is less than the loss previously accrued or the liability previously recognized ultimately resulting in the recognition of a settlement gain. In no event shall the settlement gain exceed the amount previously recognized as a loss. Any part of the settlement gain that is not recognized would be recognized as part of the business combination accounting—that is, effectively subsumed in goodwill. For example, if the acquirer had accrued a liability for a loss contract or a lawsuit prior to the business combination and the settlement loss is less than the amount accrued, the gain should be recognized as the difference between the amount previously accrued and the settlement loss. View C proponents believe their view mitigates measurement concerns because the gain recognized will never exceed an amount previously recognized as an expense (loss) and, therefore, does not affect cumulative retained earnings.

Classification

37. If the Task Force does not reach a consensus that the full fair value of the contractual relationship always should be recognized as a settlement loss (or gain) (View A for both Issue 1 and Issue 2), a portion of the fair value associated with the preexisting relationship may be included as part of the business combination. Some of that fair value may be assets that are contractual-based intangible assets from the perspective of a marketplace participant. However, after the business combination and the two entities are combined, the related contract is effectively terminated and a settlement gain or loss is recognized so that there is no longer a contractual-based intangible asset from the perspective of the combined entity. Therefore, in order for the asset to be recognized by the combined entity as an intangible asset apart from goodwill, it must meet either the legal criterion or the separability criterion in FAS 141. The FASB staff observes that for certain of those assets there is little debate over whether the asset should be recognized apart from goodwill—for example, the contract-in-place value of an at-the-market supply contract would generally not meet either the legal criterion or the separability criterion in FAS 141 and would, therefore, be subsumed in goodwill. However, there are divergent views as to whether the acquired entity's asset that arose solely from the acquired entity's contractual right to use the acquirer's existing recognized or unrecognized intangible

assets (hereinafter referred to as "reacquired right") should be recognized as intangible assets apart from goodwill.

38. The FASB staff suggests that when considering the alternative views for Issue 4, the Task Force should consider the following example in which the acquirer reacquires previously granted technology rights. However the alternative views for Issue 4 would also be applicable when considering the classification of other types of rights such as reacquired franchise or distribution rights.

> **Example 3**
> Technology Company X acquires Company Y, an operating company that had previously licensed technology from Company X. The license provided Company Y with the exclusive rights to use the technology in the United States. Company X pays $50 million (net of liabilities assumed) to acquire Company Y (fair value of Company Y based on what marketplace participants would be willing to pay).
> Assume that included in the total fair value of Company Y is an intangible asset with a fair value of $10 million related to the exclusive rights granted by Company X to use its technology in the United States.

Issue 4: Whether the acquirer should recognize, apart from goodwill, an acquired entity's intangible asset that, before the business combination, arose solely from the acquired entity's contractual right to use the acquirer's existing recognized or unrecognized intangible assets.

View A: The reacquired right should be recognized as an intangible asset apart from goodwill.

39. View A proponents believe that the reacquired right should be considered an intangible asset apart from goodwill because it meets the legal and/or the separability criterion in FAS 141.

40. Some View A proponents believe that, in many cases, the reacquired right would meet the legal criterion because the underlying asset to which the right was granted arises from legal rights (that is, it is either registered or otherwise provided legal protection). For example, an entity that acquires previously granted rights to its legally registered trade name is acquiring an

asset that should be recognized as an intangible asset apart from goodwill under the legal criterion in FAS 141. In those circumstances, the acquirer would not need to consider the separability criterion.

41. Other View A proponents do not believe that the reacquired right would meet the legal criterion because they believe the legal criterion should be considered from the perspective of the acquired entity. In the above example, the registered trade name is a legal asset of the acquirer; however, the acquired entity only has legal rights to that asset via a contract. When that contract is effectively terminated, those View A proponents believe that the asset is no longer a legal asset of the acquired entity. However, those View A proponents believe that the reacquired right would meet the separability criterion in FAS 141 as discussed below.

42. All View A proponents believe that the reacquired rights would meet the separability criterion because there is evidence of an exchange transaction for the asset (the acquirer had granted the right previously). View A proponents note that paragraph A11 of FAS 141 states (in part):

> Exchange transactions provide evidence that an intangible asset is separable from the acquired entity and might provide information that can be used to estimate its fair value. An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type (even if those exchange transactions are infrequent and regardless of whether the acquiring entity is involved in them).

View A proponents note that recognizing the reacquired right as an intangible asset apart from goodwill is consistent with the objective of FAS 141 to distinguish intangible assets from goodwill. They observe that subsuming the reacquired right into goodwill could result in nonamortization of a finite-lived intangible asset.

43. In Example 3, View A proponents believe that the $10 million attributable to the reacquired technology rights should be recorded as an intangible asset apart from goodwill.

View B: The reacquired right should not be recognized as an intangible asset apart from goodwill.

44. View B proponents agree with View A proponents that, when applying the separability criterion in FAS 141, evidence of an exchange transaction provides evidence of separability. However, View B proponents do not believe that the guidance in paragraph A11 of FAS 141 is applicable to assets that arise solely from contractual or legal rights. They note that the first sentence of paragraph A11 of FAS 141 states (in part):

> If an acquired intangible asset does *not* arise from contractual or other legal rights, paragraph 39 requires that it be recognized as an asset apart from goodwill only if it is separable….

45. View B proponents note that a granted right (for example, a franchise right) is an example of a contractual-based intangible asset in paragraph A14 of FAS 141 because it arises from contractual rights. View B proponents do not believe that a granted right would meet the legal criterion because they believe the legal criterion should be considered from the perspective of the acquired entity and that the acquired entity only has legal rights to that asset via a contract. When the contract is effectively terminated, View B proponents believe the asset is no longer a contractual or legal asset of the acquired entity.

46. View B proponents also believe that paragraph A11 of FAS 141 is only applicable to the subset of intangible assets that do *not* arise from contractual or legal rights (for example, customer lists, unpatented technology, title plants). View B proponents believe that the granted right is not in that subset. View B proponents also believe that the reacquired right does not "fit" in any other example categories of intangible assets listed in paragraph A14 of FAS 141 (that is, reacquired rights are not "marketing-related," "customer-related," "artistic-related," or "technology-based"). Therefore, View B proponents believe that since (a) the reacquired right no longer meets the contractual criterion (when the contract is, in effect, terminated in conjunction with the business combination), (b) the reacquired right does not meet the legal criterion, and (c) the separability criterion is not applicable, the reacquired right cannot be considered an intangible asset apart from goodwill.

47. In the above example, View B proponents believe that the $10 million attributable to the reacquired technology would not be recognized as an intangible asset apart from goodwill.

48. View B proponents observe that paragraph A11 of FAS 141 indicates "an acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for *that type of asset or an asset of a similar type*" (emphasis added). Considering an example in which Fast Food Company X acquires Fast Food Company Y (an unrelated entity), View B proponents believe that the application of View A would require Fast Food Company X to assign value to franchise rights intangibles for every location in the region where a Fast Food Company Y franchise agreement could potentially be established in the future. View B proponents also observe that the same rationale would apply when performing Step 2 of the goodwill impairment test because FAS 142 requires an entity to allocate the fair value of a reporting unit to its individual assets and liabilities as if the reporting unit had been acquired in a business combination. In other words, there is potentially no limit to the number of intangible assets that would be required to be recognized under View A.

49. Certain opponents of View B disagree that a View A conclusion would require an entity to assign value to all potential locations that might be separated and sold in the future in the Step 2 goodwill impairment test. In the franchise example, they believe that only those locations that previously had been separated, sold, and then repurchased would meet the separability criterion for the Step 2 goodwill impairment test. Opponents of View B also observe that under View B, if a Step 2 goodwill impairment test were to be performed immediately after the business combination, considering the fact pattern in Example 3, Company X may have an immediate impairment of goodwill of $10 million because the fair value of its internally generated technology intangible would have increased by $10 million as a result of the reacquired rights but that incremental value would have been recognized as goodwill.

Disclosures

50. Some Task Force members have suggested that certain disclosures should be required for business combinations between parties with a preexisting relationship. Therefore, the Task

Force should consider whether a consensus on this Issue should include certain disclosure requirements such as:

a. The nature of the preexisting relationship
b. The nature of any settlement of the preexisting relationship
c. The fair value of the acquired entity's assets and liabilities that were settled, including how fair value was determined (whether based on quoted prices or on the results of other valuation techniques, including the extent to which market inputs were used)
d. The carrying amount of the acquirer's related assets or liabilities, if any
e. The amount of the settlement gain or loss recognized.

Transition

51. The FASB staff recommends that any consensuses on recognition and measurement of a settlement of a preexisting relationship in a business combination should be applied prospectively to business combinations completed in reporting periods beginning after Board ratification of the consensus. Early application should be permitted for business combinations completed in periods for which financial statements have not been issued.

52. The FASB staff observes that any consensus on Issue 4 (Classification) may affect both an entity's recognized intangible assets and goodwill at the date the consensus is initially applied and an entity's goodwill impairment test. In Step 2 of a goodwill impairment test, FAS 142 requires an entity to allocate the fair value of a reporting unit to the individual assets and liabilities to determine the implied fair value of the goodwill. An entity should allocate the fair value as if the reporting unit had been acquired in a business combination. Issue 4 affects how purchase price is allocated in a business combination and, accordingly, it also affects the goodwill impairment test.

<u>Issue 4, View A</u>

53. If the Task Force reaches a consensus that a reacquired right should be recognized as an intangible asset apart from goodwill, the FASB staff believes that the Task Force should consider several transition alternatives because (a) an entity may not have information available to

separately recognize a reacquired right that had previously been subsumed in goodwill and (b) separate recognition of the reacquired right may result in a larger or smaller goodwill impairment charge. Those transition alternatives are as follows:

Alternative 1: Prospective

54. Under Alternative 1, an entity should apply the consensus on Issue 4 prospectively to business combinations and goodwill impairment tests completed in reporting periods beginning after Board ratification of the consensus. Entities would be prohibited from reclassifying amounts recognized in prior periods. Any goodwill impairment charge as a result of the application of this consensus should be reported in operating income. Proponents of Alternative 1 note that before an entity allocates fair value in Step 2 of the goodwill impairment test, the fair value of the reporting unit must be below its carrying amount. Accordingly, proponents believe that the recognition of a goodwill impairment charge in operating income is appropriate. Proponents of Alternative 1 also note that the approach is consistent with the transition for Issue 02-17. Opponents of Alternative 1 note that it may result in a larger or smaller goodwill impairment charge.

Alternative 2: Modified Prospective

55. Same as Alternative 1, except that prior period amounts should be reclassified to conform to the requirements of the consensus considering the guidance in Topic D-100. Any effects on amortization should be accounted for prospectively. Opponents of Alternative 2 note that entities may not have separately identified and measured at fair value the reacquired right in the initial recording of the business combination and subsequently maintained accounting records for that asset apart from goodwill. Therefore, it may not be possible for some entities to reclassify prior period amounts. For those entities, it may result in a larger or smaller goodwill impairment charge.

Alternative 3: Modified Prospective with Transitional Goodwill Impairment Test

56. Same as Alternative 2, except that entities would be required to perform a goodwill impairment test on the initial application of the consensus and any goodwill impairment charge would be recognized as a cumulative effect of a change in accounting principle. Alternative 2 would mitigate the concerns expressed in Alternative 1 and Alternative 2 (if the reacquired rights cannot be reclassified) regarding possible goodwill impairment charges resulting from not reclassifying prior period amounts as those charges would be "below the line". Alternatively, this alternative could require an entity to identify and record as a cumulative effect adjustment the portion of the goodwill impairment charge that relates solely to the application of the consensus. That is, an entity would be required to perform a goodwill impairment test "with" and "without" the application of the consensus on Issue 4 and, if an entity fails Step 1, any difference in the measured impairment under Step 2 would be recognized as a cumulative effect adjustment. If the entity is unable to isolate the effect of the consensus in its impairment charge, it should recognize the full amount in operating income.

Alternative 4: Restatement

57. Require retroactive application of the consensus to previous business combinations and impairment tests.

Issue 4, View B

58. If the Task Force reaches a consensus on View B for Issue 4, the FASB staff recommends that it should be applied prospectively to business combinations and impairment tests completed in reporting periods beginning after Board ratification of the consensus and that prior period amounts in the statements of financial position should be reclassified to conform with the requirements of the consensus. Any effects on amortization or impairment should be accounted for prospectively. That transition would be consistent with FAS 141 transition for intangible assets that were previously recognized apart from goodwill (for example, assembled workforce) but that no longer meet the criteria for separate recognition under FAS 141.