Title: Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination

[Nullified by FAS 141(R)]

Dates Discussed: September 11–12, 2002; October 25, 2002

References:
- FASB Statement No. 141, Business Combinations
- FASB Statement No. 141 (revised 2007), Business Combinations
- FASB Statement No. 142, Goodwill and Other Intangible Assets
- FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements

ISSUE

1. Intangible assets often represent legal rights that arise from contracts, statutes, or other means. Some intangible assets are exchangeable, while others cannot be separated from the entity. Statement 141 requires that an intangible asset be recorded apart from goodwill in either of the following situations:

   • The intangible asset arises from contractual or other legal rights, regardless of whether they are separable from the entity (the contractual-legal criterion).
   • The intangible asset is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so) either individually or in combination with a related contract, asset, or liability (the separability criterion).

2. The Board provided implementation guidance in Appendix A of Statement 141 to help constituents identify intangible assets. That guidance includes an illustrative list of intangible assets commonly acquired in a business combination. One particular category discussed was customer-related intangible assets. Paragraphs A18–A21 of Statement 141 state:
Customer-Related Intangible Assets

Customer lists

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

Order or production backlog

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

Customer contracts and related customer relationships

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

Noncontractual customer relationships

A21. If a customer relationship does not arise from a contract, this Statement requires that the relationship be recognized as an intangible asset apart from goodwill if it meets the separability criterion. Exchange transactions for the same asset or a similar type of asset provide evidence
of separability of a noncontractual customer relationship and might also provide information about exchange prices that should be considered when estimating its fair value. For example, relationships with depositors are frequently exchanged with the related deposits and, thus, meet the criteria for recognition as an intangible asset apart from goodwill.

3. The glossary to Statement 141 defines the term *customer relationship* as follows:

   For purposes of this Statement, a customer relationship exists between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer and (b) the customer has the ability to make direct contact with the entity. Relationships may arise from contracts (such as supplier contracts and service contracts). However, customer relationships may arise through means other than contracts, such as through regular contact by sales or service representatives.

4. Questions have arisen regarding certain customer-related intangible assets acquired in a business combination. Consider the following scenarios:
   
   **Scenario 1**

   Company A acquired Company B on December 31, 20X1. Company B has a sales contract that will last for five years with Customer X. Company B and Company A both believe that Customer X will renew that contract for five years after the end of the current contract.

   **Scenario 2**

   Company A acquired Company B on December 31, 20X1. Company B has two distinct lines of business, Product A and Product B. Customer X purchases both Product A and Product B from Company B. Company B has a contract with Customer X to be the exclusive provider of Product A; however, there is no contractual relationship for the supply of Product B. Company B and Company A both believe that there is only one overall customer relationship with Customer X.
5. The issues are:

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

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

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

EITF DISCUSSION

6. The Task Force reached a consensus on Issue 1 that the contractual-legal and the separability criteria do not restrict the use of certain assumptions that would be used in estimating the fair value of an intangible asset. [Note: This consensus has been nullified by Statement 141(R). See STATUS section.] Assumptions that marketplace participants would consider, such as expectations of future contract renewals and other benefits related to the intangible asset, must be considered in the estimate of its fair value.
7. The Task Force observed that the contractual-legal and the separability criteria are used in Statement 141 to identify whether an intangible asset should be recorded apart from goodwill. Those criteria, however, do not provide guidance as to how to measure and record an intangible asset. The criteria are intended to ensure consistent recognition of acquired intangible assets. [Note: See STATUS section.]

8. The Task Force reached a consensus on Issue 2 that the guidance in paragraph A20 of Statement 141 that states “if an entity establishes relationships with its customers through contracts, those customer relationships would arise from contractual rights,” applies if an entity has a practice of establishing contracts with its customers, regardless of whether a contract is in existence at the date of acquisition. [Note: This consensus has been nullified by Statement 141(R). See STATUS section.]

9. The Task Force observed that the consensus in this Issue provides guidance only on when to recognize a customer relationship intangible asset apart from goodwill. The Task Force further observed that factors such as the lack of contractual rights or separability may have an impact on the fair value of that asset.

10. The Task Force reached a consensus on Issue 3 that an order or a production backlog arising from contracts such as purchase or sales orders (even if the purchase or sales orders are cancelable) as described in paragraph A19 of Statement 141 is considered a contract subject to paragraph A20. [Note: This consensus has been
nullified by Statement 141(R). See STATUS section.] The Task Force observed that under that conclusion, if an entity had a customer relationship with customers through those types of contracts, that customer relationship arises from contractual rights and therefore meets the contractual-legal criterion for recognition as an intangible asset apart from goodwill.

11. The Task Force observed that implicit in the consensuses reached in Issues 1, 2, and 3 is the fact that a customer contract and the related customer relationship may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ. [Note: See STATUS section.]

12. The examples in Exhibit 02-17A illustrate the consensuses reached in this Issue. [Note: These consensuses has been nullified by Statement 141(R). See STATUS section.]

**Transition**

13. The Task Force reached a consensus that the guidance in this Issue should be applied to business combinations consummated and goodwill impairment tests performed after October 25, 2002. [Note: This consensus has been nullified by Statement 141(R). See STATUS section.]

**STATUS**

14. Statement 141(R), which was issued in December 2007, replaces Statement 141 and nullifies this Issue. However, this Issue still applies to mergers and acquisitions by not-for-profit organizations, which will be further considered as part of a separate FASB
project that was exposed for comment in proposed Statements, *Not-for-Profit Organizations: Mergers and Acquisitions*, and *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition*. Statement 141(R) is effective for business combinations with an acquisition date on or after the beginning of the first annual reporting period beginning on or after 12/15/08.

15. No further EITF discussion is planned.
EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 02-17

Example 1

BigCo acquired LittleCo in a business combination on December 31, 20X2. LittleCo has a five-year agreement to supply goods to BuyerCo. Both LittleCo and BigCo believe that BuyerCo will renew the supply agreement at the end of the current contract. The supply agreement is not separable.

Evaluation: The supply agreement (whether cancelable or not) meets the contractual-legal criterion and, therefore, must be recorded at fair value apart from goodwill. Additionally, since LittleCo establishes its relationship with BuyerCo through a contract, the customer relationship with BuyerCo meets the contractual-legal criterion and the customer relationship must also be recorded at fair value apart from goodwill. In determining the fair value of the customer relationship, BigCo is required to consider assumptions such as the expected renewal of the supply agreement.

Example 2

ParentCo acquired VendorCo in a business combination on December 31, 20X2. VendorCo manufactures goods in two distinct lines of business—sporting goods and electronics. RetailCo purchases both sporting goods and electronics from VendorCo. VendorCo has a contract with RetailCo to be the exclusive provider of sporting goods to RetailCo; however, there is no contract for the supply of electronics to RetailCo. Both
VendorCo and ParentCo believe that there is only one overall customer relationship between VendorCo and RetailCo.

**Evaluation:** The contract to exclusively provide sporting goods to RetailCo (whether cancelable or not) meets the contractual-legal criterion and, therefore, must be recorded at fair value apart from goodwill. Additionally, since VendorCo establishes its relationship with RetailCo through a contract, the customer relationship with RetailCo meets the contractual-legal criterion and must also be recorded at fair value apart from goodwill. Since there is only one customer relationship with RetailCo, the fair value of that relationship would incorporate assumptions regarding VendorCo’s relationship with RetailCo related to both sporting goods and electronics.

If, however, both ParentCo and VendorCo believed that there were separate customer relationships with RetailCo—one for sporting goods and one for electronics, then the customer relationship with respect to electronics would be assessed by ParentCo to determine whether it meets either the contractual-legal criterion or the separability criterion and, if so, should be recorded at fair value apart from goodwill.

**Example 3**

Company X acquires Company Y in a business combination on December 31, 20X2. Company Y does business with its customers solely through purchase and sales orders. At December 31, 20X2, Company Y has a backlog of customer purchase orders in-house from 60 percent of its customers, all of whom are recurring customers. The other 40 percent of Company Y’s customers are also recurring customers; however, as of
December 31, 20X2, Company Y does not have any open purchase orders, or other contracts, with those customers.

**Evaluation:** The purchase orders from 60 percent of Company Y’s customers (whether cancelable or not) meet the contractual-legal criterion and, therefore, must be recorded at fair value apart from goodwill. Additionally, since Company Y has established its relationship with 60 percent of its customers through a contract, those customer relationships meet the contractual-legal criterion and must also be recorded at fair value apart from goodwill.

Because Company Y has a practice of establishing contracts with the remaining 40 percent of its customers, those customer relationships also arise through contractual rights and, therefore, meet the contractual-legal criterion. Company X must record the customer relationship for the remaining 40 percent of Company Y’s customers at fair value apart from goodwill, even though Company Y does not have contracts with those customers at December 31, 20X2.
Suggested Index Entries for Issue No. 02-17, “Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination”

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