Customer Relationship Intangible Assets

At its 10/25/02 meeting, the EITF reached a consensus on EITF Issue No. 02-17, Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination.

Background. 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. SFAS No. 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).

The FASB provided implementation guidance in Appendix A of SFAS No. 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.

EITF A18-A21 of SFAS No. 141 addresses the following customer relationship intangible assets: (a) customer lists; (b) order or production backlog; (c) customer contracts and related customer relationships; and (d) noncontractual relationships.

The issues are:

- **Issue 1** - When an entity recognizes an intangible asset pursuant to ¶39 of SFAS No. 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 ¶A20 of SFAS No. 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 ¶A19 of SFAS No. 141 are considered contracts subject to the guidance in ¶A20 of SFAS No. 141.

EITF Consensus. The EITF reached a consensus that:

- **Issue 1** - The contractual-legal and separability criteria do not restrict the use of certain assumptions in estimating the fair value of customer relationships. Assumptions such as the
expectations of future contract renewals and other benefits related to the customer relationship must be considered in the estimate of fair value.

- **Issue 2** - The guidance in ¶A20 of SFAS No. 141 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.

- **Issue 3** - An order or a production backlog arising from contracts such as purchase or sales orders as described in ¶A19 of SFAS No. 141 is considered a contract subject to ¶A20.

The EITF also reached a consensus that the guidance in Issue 02-17 should be applied to business combinations and goodwill impairment tests performed after 10/25/02.

### Goodwill Impairment Test

At its 9/11-9/12/02 meeting, the EITF reached a consensus on Issue No. 02-13, **Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in FASB Statement No. 142, Goodwill and Other Intangible Assets**. The EITF also provided two examples that demonstrate the consensus.

**Background.** SFAS No. 142 requires goodwill to be tested for impairment at the reporting unit level at least annually using a two-step impairment test. Step 1 of the test is a screen used to identify whether a goodwill impairment may exist. In Step 1, an entity compares the fair value of a reporting unit with its carrying amount. If a reporting unit’s carrying amount exceeds its fair value, a goodwill impairment may exist. Step 2 of the test must then be performed to measure the amount of impairment, if any.

In Step 2, an entity compares the implied fair value of goodwill with its carrying amount. An impairment loss is measured by the excess of the carrying amount of goodwill over its implied fair value. The implied fair value of goodwill is determined in the same manner that goodwill is measured in a business combination under SFAS No. 141. That is, an entity allocates the fair value of a reporting unit to the assets and liabilities of that unit (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the price paid to acquire the reporting unit.

Pursuant to SFAS No. 142, **all** goodwill acquired in a business combination is assigned to one or more reporting units. In addition, an entity’s assets (excluding goodwill) and liabilities, including corporate assets and liabilities, are assigned (or allocated) to one or more reporting units if both of the following two criteria are met: (a) the asset will be employed in or the liability relates to the operations of a reporting unit; and (b) the asset or liability will be considered in determining the fair value of the reporting unit.

In the context of recognizing and measuring impairment of goodwill, questions have arisen regarding how an entity would account for differences between the book and tax bases of assets and liabilities (i.e., deferred tax balances) in determining: (a) a reporting unit’s fair value; (b) a reporting unit’s carrying amount; and (c) the implied fair value of goodwill.

The issues are:

- **Issue 1** - Whether the fair value of a reporting unit would be estimated by assuming that the unit would be bought or sold in a nontaxable transaction versus a taxable transaction.
- **Issue 2** - Whether deferred income taxes would be included in the carrying amount of a reporting unit for purposes of Step 1 of the SFAS No. 142 goodwill impairment test.
- **Issue 3** - For purposes of determining the implied fair value of a reporting unit’s goodwill in Step 2 of the SFAS No. 142 goodwill impairment test, what income tax bases an entity would use for a reporting unit’s assets and liabilities in order to measure deferred tax assets and liabilities (i.e., would an entity use the existing income tax bases or assume new income tax bases for the unit’s assets and liabilities).

**EITF Consensus.** The EITF reached a consensus on Issue 1 that the determination of whether to estimate the fair value of a reporting unit by assuming that the unit could be bought or sold in a nontaxable transaction versus a taxable transaction is a matter of judgment that depends on the relevant facts and circumstances and must be evaluated carefully on a
case-by-case basis. The EITF listed a number of matters that should be considered.

The EITF also observed that in determining the feasibility of a nontaxable transaction, an entity would consider, among other factors: (a) whether the reporting unit could be sold in a nontaxable transaction; and (b) whether there are any income tax laws and regulations or other corporate governance requirements that could limit an entity’s ability to treat a sale of the unit as a nontaxable transaction.

The EITF reached a consensus on Issue 2 that deferred income taxes would be included in the carrying value of the reporting unit, regardless of whether the fair value of the reporting unit will be determined assuming it would be bought or sold in a taxable or nontaxable transaction.

The EITF reached a consensus on Issue 3 that an entity would use the income tax bases of a reporting unit’s assets and liabilities implicit in the tax structure assumed in its estimation of fair value of the reporting unit in Step 1 (i.e., an entity would use its existing income tax bases if the assumed structure used to estimate the fair value of the reporting unit was a nontaxable transaction, and it would use new income tax bases if the assumed structure was a taxable transaction).

The EITF observed that in performing Step 2 of the goodwill impairment test, the implied fair value of a reporting unit’s goodwill is determined in the same manner that the amount of goodwill recognized in a business combination accounted for in accordance with SFAS No. 141 is determined. ¶38 of SFAS No. 141 indicates that a deferred tax liability or asset is recognized for differences between the assigned values and the income tax bases of the recognized assets acquired and liabilities assumed in a business combination accounted for in accordance with SFAS No. 141 is determined. ¶38 of SFAS No. 141 indicates that a deferred tax liability or asset is recognized for differences between the assigned values and the income tax bases of the recognized assets acquired and liabilities assumed in a business combination accounted for in accordance with ¶30 of SFAS No. 109.

Note Concerning Convertible Debt. At its 9/11-9/12/02 meeting, the EITF also reached a consensus on Issue No. 02-15, Determining Whether Certain Conversions of Convertible Debt to Equity Securities Are within the Scope of FASB Statement No. 84, Induced Conversions of Convertible Debt. The issue is whether SFAS No. 84 applies when the “offer” for consideration in excess of the original conversion terms is made by the debt holder rather than the debtor.

Reacquisition of Financial Assets

At its 11/21/02 meeting, the EITF reached a partial consensus on EITF Issue No. 02-9, Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold.

Background. A key concept in SFAS No. 140 is that a transferred asset that has been accounted for as sold is accounted for as “re-purchased” if the basis for that sale accounting becomes invalid subsequent to the initial accounting for the transaction. That concept is articulated in ¶55 of SFAS No. 140. Two circumstances that have raised questions about the application of ¶55 occur when the provisions of ¶55 are triggered because: (a) a qualifying SPE becomes nonqualifying; and (b) the transferor holds a contingent right such as a contingent call option on the transferred financial assets (e.g., a removal of accounts provision or “ROAP”) and the contingency has been met.

A qualifying SPE may become nonqualifying or “tainted” for several reasons, including a decision by the outside beneficial interest holders to grant the SPE decision-making powers that are prohibited for qualifying SPEs. Under the requirements of ¶55, a qualifying SPE that becomes tainted will generally result in the “re-purchase” by the transferor of all assets transferred to and held by the SPE.

The issues are:

- **Issue 1** - How the transferor would account for retained beneficial interests when the underlying assets are re-recognized under the provisions of ¶55 because the transferor’s contingent right (e.g., a ROAP or other contingent call option on the transferred financial assets) becomes exercisable, and, in particular, how much of any gain or loss would the transferor recognize when ¶55 is applied.

- **Issue 2** - How assets of an SPE that was formerly considered qualifying would be accounted for when the entire SPE becomes nonqualifying under the provisions of ¶55, including whether
the transferor would recognize a gain or loss when ¶55 is applied.

- **Issue 3** - Whether, under any circumstances, a loan loss allowance would initially be recorded for loans that do not meet the definition of a “security” when they are re-recognized under the provisions of ¶55.

- **Issue 4** - How re-recognition under ¶55 of assets sold affects the accounting for the related servicing asset.

At its 9/11-9/12/02 meeting, the EITF reached a consensus on Issue 3 that under no circumstances would a loan loss allowance be initially recorded for loans that do not meet the definition of a “security” when they are re-recognized pursuant to ¶55.

**EITF Consensus.** The EITF reached a consensus on Issue 1 that upon application of ¶55, no gain or loss would be recognized in earnings with respect to any beneficial interests retained by the transferor. A gain or loss may be recognized only with respect to the “re-purchased” third-party beneficial interests (the portion of the transferred assets that were sold) and only if a ROAP or similar contingent right held by the transferor that is not accounted for as a derivative under SFAS No. 133 is not at-the-money, resulting in the fair value of those beneficial interests being greater or less than related obligations to the transferee. Beneficial interests would be evaluated periodically for possible impairment, including at the time ¶55 is applied.

The EITF discussed but was not able to reach a consensus on either Issue 2 or Issue 4. Further discussion is expected at a future EITF meeting.

**Modification of Debt Instruments - Debtor’s Accounting**

At its 3/20-3/2102 meeting, the EITF reached a consensus on Issue No. 02-4, Determining Whether a Debtor’s Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings. The guidance in Issue No. 02-4 supersedes the consensus reached in EITF Issue No. 89-15, Accounting for a Modification of Debt Terms When the Debtor Is Experiencing Financial Difficulties. Issue No. 02-4 provides guidance on: (a) determining whether the debtor is experiencing financial difficulties; and (b) determining whether the creditor granted a concession.

**Background.** ¶2 of SFAS No. 15 states that: “A restructuring of debt constitutes a troubled debt restructuring for purposes of this Statement if the creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession to the debtor that it would not otherwise consider.” ¶61 of SFAS No. 15 further explains that the determination of whether a debt restructuring is a troubled debt restructuring should focus on whether those economic and legal considerations “in effect compel the creditor to restructure a receivable in ways more favorable to the debtor than the creditor would otherwise consider.”

¶5 of SFAS No. 15 provides a list of characteristics or factors that may be present in a troubled debt restructuring. ¶7 provides a list of characteristics or factors that, if present, indicate that a modification or exchange of debt should not necessarily be considered a troubled debt restructuring even if the debtor is experiencing financial difficulty. ¶¶61 and 62 of SFAS No. 15 provide additional guidance further clarifying the meaning of troubled debt restructuring for purposes of the Statement.

At its 1/23-1/24/02 meeting, the EITF observed that under the provisions of SFAS No. 15, the determination of whether a modification or exchange of a debt instrument should be accounted for as a troubled debt restructuring requires consideration of all specific facts and circumstances surrounding the transaction. The EITF reached a consensus that no single characteristic or factor, taken alone, is determinative of whether a modification or exchange is a troubled debt restructuring under SFAS No. 15. The EITF observed that, consistent with the scope of SFAS No. 15, the scope of Issue No. 02-4 is not limited to marketable debt instruments.

**EITF Consensus.** The EITF reached a consensus that a model should be applied by a debtor when determining whether a modification or an exchange of debt instruments is within the scope of SFAS No. 15. The model concludes that a modification or an exchange is within the scope of SFAS No. 15 if a “yes” answer is given to both of the following questions:
• Is the debtor experiencing financial difficulties (see below)?
• Has the creditor granted a concession (see below)?

A “no” answer to either of the above two questions results in the conclusion that the modification or exchange is not within the scope of SFAS No. 15. The EITF noted that if an entity concludes that the modification or exchange is not within the scope of SFAS No. 15, the entity would apply the provisions of EITF Issue No. 96-19, Debtor’s Accounting for a Modification or Exchange of Debt Instruments.

The EITF also reached a consensus that the following factors have no relevance in the determination of whether a modification or an exchange is within the scope of SFAS No. 15:

• The amount invested in the old debt by the current creditors;
• The fair value of the old debt immediately before the modification or exchange compared to the fair value of the new debt at issuance; and
• Transactions among debt holders.

In addition, the EITF noted that the length of time the current creditors have held the investment in the old debt is not relevant in the determination of whether a modification or exchange is within the scope of SFAS No. 15 unless all the current creditors recently acquired the debt from the previous debt holders to effect what is in substance a planned refinancing.

**Determining Whether the Debtor Is Experiencing Financial Difficulties.** The EITF reached a consensus that the following factors are indicators that the debtor is experiencing financial difficulties:

• The debtor is currently in default on any of its debt;
• The debtor has declared or is in the process of declaring bankruptcy;
• There is significant doubt as to whether the debtor will continue to be a going concern;
• Currently, the debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange;
• Based on estimates and projections that only encompass the current business capabilities, the debtor forecasts that its entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity; and
• Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a non-troubled debtor.

The EITF reached a consensus that changes in an investment grade credit rating [e.g., from Moody’s Aaa to A2] are not considered a deterioration in the debtor’s creditworthiness for purposes of Issue No. 02-4. Conversely, a decline in credit rating from investment grade to non–investment grade [e.g., Moody’s Ba1 or lower] is considered a deterioration in the debtor’s creditworthiness for purposes of Issue No. 02-4.

The EITF also reached a consensus that the following factors have no relevance in the determination of whether a modification or an exchange is within the scope of SFAS No. 15:

• The amount invested in the old debt by the current creditors;
• The fair value of the old debt immediately before the modification or exchange compared to the fair value of the new debt at issuance; and
• Transactions among debt holders.

In addition, the EITF noted that the length of time the current creditors have held the investment in the old debt is not relevant in the determination of whether a modification or exchange is within the scope of SFAS No. 15 unless all the current creditors recently acquired the debt from the previous debt holders to effect what is in substance a planned refinancing.

**Determining Whether the Creditor Granted a Concession.** The EITF reached a consensus that a creditor is deemed to have granted a concession if the debtor’s effective borrowing rate on the restructured debt is less than the effective borrowing rate of the old debt immediately prior to the restructuring. Guidance is provided concerning the calculation of the effective
borrowing rate on the restructured debt.] However, the EITF reached a consensus that although considered rare, if there is persuasive evidence that the decrease in the effective borrowing rate is due solely to a factor that is not captured in the mathematical calculation (e.g., additional collateral), the creditor may not have granted a concession and the modification or exchange should be evaluated based on the substance of the modification.

The EITF also reached a consensus that notwithstanding the above, if an entity has recently restructured the debt and is currently restructuring that debt again, the effective borrowing rate of the restructured debt (after giving effect to all the terms of the restructured debt including any new or revised options or warrants, any new or revised guarantees or letters of credit, etc.) should be calculated using an EITF-prescribed formula that solves for a discount rate.

**Modification of Debt Instruments - Creditor’s Accounting**

At its 1/23-1/24/02 meeting, the EITF reached a consensus on Issue No. 01-7, *Creditor’s Accounting for a Modification or an Exchange of Debt Instruments*. The issue is how a creditor would evaluate whether a modification of the terms of a debt instrument as a result of a refinancing or restructuring (other than a troubled debt restructuring) is more than minor under ¶12 of SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

**Background.** When a creditor and a debtor agree to modify the terms of an existing debt instrument or to exchange debt instruments (other than in a troubled debt restructuring), each must determine whether the modification or exchange would be accounted for as: (a) the creation of a new debt instrument and the extinguishment of the original debt instrument; or (b) the continuation of the original debt instrument (as modified). Guidance for making that determination is provided for creditors in SFAS No. 91 and for debtors in EITF Issue No. 96-19.

¶12 of SFAS No. 91 states that:

“If the terms of the new loan resulting from a loan refinancing or restructuring other than a troubled debt restructuring are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan shall be accounted for as a new loan. This condition would be met if the new loan’s effective yield is at least equal to the effective yield for such loans. Any unamortized net fees or costs and any prepayment penalties from the original loan shall be recognized in interest income when the new loan is granted.” [Footnote reference omitted.]

¶13 of SFAS No. 91 states that:

“If the refinancing or restructuring does not meet the condition set forth in paragraph 12 or if only minor modifications are made to the original loan contract, the unamortized net fees or costs from the original loan and any prepayment penalties shall be carried forward as a part of the net investment in the new loan.” [emphasis added]

Thus, SFAS No. 91 requires a creditor to account for the modified debt instrument as a new debt instrument if the following two criteria are met: (a) the modified debt instrument’s effective yield is at least equal to the effective yield for a comparable loan to a debtor with similar collection risks who is not refinancing or restructuring; and (b) modifications of the original debt instrument are more than minor. However, SFAS No. 91 and the related interpretive literature do not provide factors to be considered or criteria to be used in evaluating whether a modification of a debt instrument is more than minor.

The foregoing provisions of SFAS No. 91 preclude a creditor from accounting for a loan refinancing or restructuring as a new debt instrument if the terms of the new loan are not at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring. In those fact patterns, the definition of minor is irrelevant. Accordingly, those fact patterns are not within the scope of Issue No. 01-7. Consistent with the scope of SFAS No. 91, Issue No. 01-7 only applies to transactions between a creditor and a debtor.
**EITF Consensus.** The EITF reached a consensus that a modification of a debt instrument would be considered more than minor under ¶13 of SFAS No. 91 if the present value of the cash flows under the terms of the new debt instrument is at least 10% different from the present value of the remaining cash flows under the terms of the original instrument. The EITF reached a consensus that if the difference between the present value of the cash flows under the terms of the new debt instrument and the present value of the remaining cash flows under the terms of the original debt instrument is less than 10%, a creditor would evaluate whether the modification is more than *minor* based on the specific facts and circumstances (and other relevant considerations) surrounding the modification. The EITF also reached a consensus that the guidance in Issue No. 96-19 would be used to calculate the present value of the cash flows for purposes of applying the 10% test.