

FASB Emerging Issues Task Force

Issue No. 03-9

Title: Determination of the Useful Life of Renewable Intangible Assets under FASB Statement No. 142, *Goodwill and Other Intangible Assets*

Document: Issue Summary No. 2*

Date Prepared: June 15, 2004

FASB Staff: McBride (ext. 394)/Westerlund (ext. 212)

Date Previously Discussed: July 31, 2003; November 12–13, 2003; March 17–18, 2004

Previously Distributed EITF Materials: Issue Summary No. 1, dated July 18, 2003; Issue Summary No. 1, Supplement No. 1, dated October 23, 2003; Working Group Report No. 1 (Issue Summary No. 1, Supplement No. 2), dated March 5, 2004

References:

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

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

FASB Concepts Statement No. 6, *Element of Financial Statements* (CON 6)

*** The alternative views presented in this Issue Summary 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.**

Background

1. Issue 03-9 addresses how the pertinent factors in sub-paragraph 11(d) of FAS 142 should be evaluated in determining whether an intangible asset, in which a marketplace participant anticipates renewal (hereinafter referred to as "renewable intangible assets"),¹ has an indefinite useful life. Renewable intangible assets include, but are not limited to, gaming licenses, taxicab medallions, cable franchises, airline route authorities, contracts to manage investments of mutual funds, and FCC licenses.

Measurement and Recognition Guidance

2. Paragraph B174 of FAS 141 indicates that judgment is required in determining the period over which future cash flows should be expected for purposes of determining the fair value of an intangible asset. Those estimates of future cash flows should incorporate assumptions that marketplace participants would use in making estimates of fair value, such as assumptions about future contract renewals *and* other benefits such as those that might result from acquisition-related synergies. In cases in which contractual or legal rights are routinely renewed, estimates of future cash flows should extend beyond the remaining contractual or legal term.

Determination of Useful Life

3. The useful life of an intangible asset is defined under FAS 142 as "the period over which an asset is expected to contribute directly or indirectly to future cash flows." There is a direct link, therefore, between the period in which an entity estimates future cash flows from a renewable intangible asset under FAS 141 and the period in which that asset is amortized under FAS 142. As described in paragraph B44 of FAS 142, the Board concluded that "the amortization periods for intangible assets should generally reflect those useful lives and, by extension, the cash flow streams associated with them."

4. FAS 142, however, provides additional guidance for the determination of the useful life of renewable intangible assets that appears to be narrower than the guidance under FAS 141. Paragraph 11 of FAS 142 requires an entity to assess whether certain "pertinent factors" limit the

¹ The term "renewable intangible assets" includes all intangible assets for which a marketplace participant assumes renewal or extension, regardless of whether the contract has explicit provisions that enable renewal or extension.

useful life of an intangible asset to the reporting entity (that is, whether the pertinent factors limit the period over which an asset is expected to contribute directly or indirectly to future cash flows). There is diversity in practice resulting from the number of views on how to evaluate whether substantial renewal costs or material modifications of the existing terms and conditions of a renewable intangible asset, pursuant to subparagraph 11(d) of FAS 142, limit the useful life of that renewable intangible asset.

Previous Discussion

5. The Task Force previously observed that the useful life of a renewable intangible asset for amortization purposes under FAS 142 should be equal to the period in which that asset is projected to contribute to an entity's cash flows under FAS 141. That raises the question of how the useful life under FAS 142 can be equal to the period in which the asset is projected to contribute to an entity's cash flows if the asset's useful life is limited by a substantial renewal cost or a material modification. In response to that question, some Task Force members observed that the estimated future cash flows associated with a renewable intangible asset may, in fact, be generated by one or more intangible assets. Those Task Force members believe that the cash flows generated subsequent to a substantial renewal cost and material modification are generated by one or more additional intangible assets.

6. At the March 17–18, 2004 EITF meeting, the Task Force discussed an approach to evaluate how substantial renewal costs and material modifications of the existing terms and conditions of the renewable intangible asset should be evaluated in determining whether a renewable intangible asset has an indefinite life. Under that approach, an entity evaluates certain criteria (such as the probability of renewal) to determine whether the renewable intangible asset is in substance a single intangible asset. If the renewable intangible asset is in substance a single intangible asset, then the renewal costs and expected modifications of the renewable intangible asset (if any) do not limit the useful life of the intangible asset. That is, the renewal costs are not "significant" and the expected modifications are not "material." The Task Force asked the FASB staff to further develop that approach.

Current Discussion

7. The following views address how substantial renewal costs and material modifications should be evaluated in the context of whether a renewable intangible asset is in substance a single intangible asset.

View A: A renewable intangible asset is in substance a single intangible asset if an entity is substantially indifferent to acquiring the renewable intangible asset or acquiring a hypothetically identical intangible asset that does not require renewal.

8. An entity is substantially indifferent to acquiring the renewable intangible asset if renewal is not expected to give rise to dissimilar risks and rewards of ownership or dissimilar cash flows as compared to a hypothetical identical intangible asset that does not require renewal.

9. View A proponents believe that judgment is required in determining whether renewal gives rise to dissimilar risks and rewards of ownership or dissimilar cash flows as compared to an identical asset that does not require renewal and that an entity should consider the following:

a. *Probability of renewal.* If a marketplace participant expects the probability of renewal to be less than reasonably assured, then renewal gives rise to dissimilar risks and rewards of ownership or cash flows as compared to a hypothetically identical intangible asset that does not require renewal.

b. *Incremental renewal costs.* If a marketplace participant expects to incur significant incremental costs in order to achieve renewal as compared to a hypothetically identical intangible asset that does not require renewal, then renewal gives rise to dissimilar risks and rewards of ownership or cash flows as compared to a hypothetically identical intangible asset that does not require renewal. Costs that a marketplace participant with a hypothetically identical intangible asset that does not require renewal would expect to incur should not be considered "incremental costs in order to achieve renewal." That is, a marketplace participant would expect such costs to be integral to the risks and rewards of ownership and cash flows associated with the asset.

c. *Modification of the existing terms and conditions.* If a marketplace participant expects that the counterparty will require modifications to the existing terms and conditions of a renewable intangible asset, then renewal gives rise to dissimilar risks and rewards of ownership or cash flows as compared to a hypothetically identical intangible asset that does not require renewal. If a renewable intangible asset is subject to substantive negotiation at renewal, there should be an expectation that the risks and rewards of ownership and cash flows will be dissimilar (either favorably or unfavorably) as compared to a hypothetical identical intangible asset that does not require renewal.

10. If the application of the criteria results in a determination that the entity is substantially indifferent to acquiring a renewable intangible asset or acquiring a hypothetically identical intangible asset that does not require renewal, then the renewable intangible asset is in substance a single asset. The entity should then apply the remaining criteria in paragraph 11 of FAS 142 in order to conclude whether the renewable intangible asset is otherwise indefinite lived. Subsequent changes in the risks and rewards of ownership or cash flows do not affect the initial decision to recognize one or more assets, but should be considered in the determination of whether events and circumstances continue to support an indefinite useful life and whether the asset is impaired.

11. If the application of the criteria results in a determination that the entity is not substantially indifferent to acquiring a renewable intangible asset or acquiring a hypothetically identical intangible asset that does not require renewal, then the renewable intangible asset is not in substance a single asset. In that instance, the entity would separately value and amortize the contractual intangible asset and the renewal intangible asset(s) (that is, the value of the ability to renew the original contractual asset). The renewal intangible asset(s) would be placed in service upon renewal, would be amortized over the renewal period, and would be subject to impairment testing under FAS 144 in all periods, both prior to and during the amortization period.

12. Opponents of View A believe that the proposed approach does not address the practice issue of how to determine whether renewal costs are substantial or whether modifications of the existing terms and conditions are material. Advocates of View A believe that the Task Force

cannot set thresholds that quantify the terms “substantial” and “material” since those determinations should be based on facts and circumstances. Advocates of View A also believe that View A will reduce the diversity in practice because View A provides entities with a context in which to evaluate subparagraph 11(d) of FAS 142.

View B: A renewable intangible asset is in substance a single intangible asset if renewal is reasonably assured.

13. Proponents of View B believe that the evaluation of whether renewal is reasonably assured is a surrogate for evaluating substantial costs and material modifications and, accordingly, believe that the Task Force does not need to define substantial cost and material modification. That is, the presence of these factors correlates with the risk of nonrenewal; if an entity evaluates whether renewal is reasonably assured, it does not need to individually evaluate substantial costs and material modification.

14. Advocates of View B believe that there is a direct correlation between (a) substantial costs and material modifications and (b) the risk of nonrenewal. For example, if renewal of an intangible asset requires an entity to incur a substantial incremental cost in order to achieve renewal, then the likelihood of renewal is less than if minimal incremental costs are required. Similarly, if there is a potential for a required modification to the terms and conditions of the intangible asset, then the likelihood of renewal is less than it is for an identical asset that is not subject to modification.

15. An entity should consider the same factors that a marketplace participant would consider in estimating the value of the intangible asset in determining whether renewal is reasonably assured, including the remaining criteria in paragraph 11 of FAS 142.

16. If a renewable intangible asset is reasonably assured of renewal indefinitely, then the asset is in substance a single asset that has an indefinite life. Subsequent changes in the risks and rewards of ownership or cash flows do not affect the initial decision to recognize one or more

assets, but should be considered in the determination of whether events and circumstances continue to support an indefinite useful life and whether the asset is impaired.

17. If a renewable intangible asset is not reasonably assured of renewal, then the renewable intangible asset is not in substance a single intangible asset. In that instance, the entity would separately value and amortize the contractual intangible asset and the renewal intangible asset(s) (that is, the value of the ability to renew the original contractual asset). The renewal intangible asset(s) would be placed in service upon renewal, would be amortized over the renewal period, and would be subject to impairment testing under FAS 144 during all periods, both prior to and during the amortization period.

18. View B opponents believe that the determination of whether a renewable intangible asset is in substance a single asset should, in part, be dependent upon an evaluation of the asset's risks and rewards of ownership and cash flows. Opponents of View B observe that changes in the risks and rewards of ownership and/or cash flows of renewable intangible assets may not correlate with a reduction in the probability of renewal. Accordingly, View B opponents are troubled by the fact that View B could result in the determination that a renewable intangible asset is in substance a single asset in cases in which the asset's risks and rewards of ownership and cash flows change. Accordingly, View B opponents believe an entity should evaluate "incremental renewal costs" and "modification of the existing terms and conditions" in addition to evaluating the probability of renewal.