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March 27, 2006

Mr. Lawrence W. Smith
Director - Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position No. 142-d, *Amortization and Impairment of Acquired Renewable Intangible Assets* (FSP 142-d)

Dear Mr. Smith:

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions.

We appreciate the opportunity to comment on the referenced document.

In summary, we support amending FASB Statement No. 142, *Goodwill and Other Intangible Assets*, to provide guidance on the amortization period for acquired renewable intangible assets that is more consistent with the manner in which fair value is determined for those assets. However, due to our confusion over a fundamental aspect of the proposed FSP, we are unsure whether the proposed FSP resolves this issue. The remainder of this letter contains our comments on the proposed FSP.

**Confusion Over the Treatment of Renewals that are Not Reasonably Assured**

FSP 142-d proposes to amend paragraph 11(d) of Statement 142 to limit consideration of renewal periods to those renewal periods that are "reasonably assured." New paragraph 15A states that "the fair value of the [acquired renewable intangible] asset shall be attributed to (a) the initial contract period of use and (b) each future renewal period …." We are unsure whether the phrase "each future renewal period" is intended to be limited to future <u>reasonably assured</u> renewal periods or not. We believe "reasonably assured" is interpreted in practice as a high

hurdle (an approximate 90 percent likelihood of occurrence).[1] If the intent is to limit attribution of fair value to the initial contract period plus reasonably assured renewal periods, we believe FSP 142-d will do little to alleviate the perceived disconnect between valuation of renewable intangible assets and assigned amortization lives.

We recommend that the Board attribute the fair value of an acquired renewable intangible asset to all renewal periods and that it combine reasonably assured renewal periods with the initial contract period. We believe such an approach has the following advantages:

- Such an approach would simplify the accounting for an acquired intangible asset that has only reasonably assured renewal periods. Not only would it eliminate the need to attribute value separately to the initial contract term and the renewal term in that situation, but it would also simplify the impairment analysis by making such acquired intangible assets subject to the FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, impairment standard rather than the Statement 142 fair value impairment standard.

- Such an approach would result in an acquired intangible asset that has a five-year initial term and one five-year reasonably assured renewal being accounted for in the same manner (amortization and impairment) as an acquired intangible asset with a 10-year term. We believe those two acquired intangible assets are economically very similar and that it makes sense for the accounting for those two intangible assets to be same.

- Such an approach would be consistent with the guidance on determining the lease term for a lease pursuant to FASB Statement No. 13, *Accounting for Leases*. In contrast, the approach set forth in FSP 142-d appears to conflict with the guidance in Statement 13 with respect to the amortization of assets under capital lease and with the guidance in EITF Issue No. 05-6, *Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination*, with respect to the amortization period for acquired leasehold improvements.

- Finally, we believe such an approach would make the accounting for finite and indefinite lived intangible assets more intellectually consistent. Paragraph 11 of Statement 142 states, "If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite." With respect to an acquired renewable intangible asset, that statement, after the amendment to paragraph 11(d) proposed by FSP 142-d, appears to treat an intangible asset with no limit to its life the same as an intangible asset with an unlimited number of reasonably assured renewals. In effect, when determining whether an

[1] Paragraph 5(f) of FASB Statement No. 13, *Accounting for Leases*, includes "reasonably assured" renewal periods and excludes cancellation provisions based on "the occurrence of some remote contingency" from its definition of a lease term. Interpreting "reasonably assured" as a 90 percent likelihood of occurrence is consistent with an interpretation that "remote" is approximately a 10 percent likelihood of occurrence.

intangible asset has an indefinite life, reasonably assured renewals are treated as part of the initial contract period.

**Method of Attributing the Fair Value of the Acquired Intangible Asset to the Contractual Period of Use and Renewal Periods**

New paragraph 15A states that "the fair value of the [acquired renewable intangible] asset shall be attributed to (a) the initial contractual period of use and (b) each future renewal period based on the relative value of the discounted cash flows." We are unsure why the Board concluded to use discounted cash flows for allocating amounts to the different components of the acquired renewable intangible asset rather than using relative fair value to allocate amounts to the different components. Because fair value incorporates the probability of renewal as well as the time value of money, we believe allocating the fair value of the acquired renewable intangible asset to its component parts based on the fair value of the component parts better reflects the economics of the acquired renewable intangible asset.

**Amortization Methods for Intangible Assets**

Nothing in the standard section of FSP 142-d or in its proposed amendments of Statement 142 addresses amortization methodologies for the different component parts of the intangible assets. In paragraph B9, the Board states that it considered requiring an amortization methodology based on relative cash flow, but it ultimately rejected that approach. However, paragraph B12 states, "The Board observed, however, that the asset's fair value determination by an income approach uses discounted cash flows and, therefore, consistent with paragraph 12 of Statement 142, using discounted cash flows for the attribution of amortization expense better represents the pattern of consumption of the economic benefits of the asset."

Did the Board intend by this statement to interpret the guidance in paragraph 12 of Statement 142 (and thus potentially affect amortization methodologies for all intangible assets)? If so, this interpretation of paragraph 12 of Statement 142 should be moved to the standard section of the FSP. Although we do not object to the Board providing interpretive guidance with respect to acceptable amortization methodologies for intangible assets, we do not agree with the assertion that an amortization pattern based on discounted cash flows always (or even usually) represents the appropriate pattern of consumption of the economic benefits of an intangible asset.

Our views on this issue are consistent with the views of the Issue 03-9 Working Group. We believe that in determining the "pattern in which the economic benefits of the intangible asset are consumed or otherwise used up" one should focus on the using up of the rights conveyed by the intangible asset rather than its cash flows. The difference between our view and the use of discounted cash flows for purposes of amortization are most easily demonstrated by an example in which the intangible asset conveys the right to provide an unlimited amount of service (or goods) to customers for a finite time period. In that situation, we believe the benefit from the intangible right is consumed equally over time regardless of the timing of cash flows. In our view, straight-line amortization appropriately allocates the cost of the intangible asset among the periods in which the intangible asset is consumed. We do not believe, for example, that a discounted cash flow based amortization methodology that results in "back ending" the amortization of an acquired intangible asset due to a combination of expected inefficiencies in the early years and exponential sales growth in the later years accurately allocates the cost of the intangible asset to the periods

in which the benefit of the intangible asset is truly consumed. Please see Attachment 1 for the portion of the Issue 03-9 Working Group report that addresses the amortization of finite lived intangibles for a more complete discussion of this issue.

We would also note that the Board did not elect to use the discounted cash flow method when it addressed, in the not too distant past, the amortization of servicing assets. Paragraph 13 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, provides that servicing assets are amortized based on expected undiscounted cash flows. In fact, earlier this month, the Board issued FASB Statement No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*, and retained the requirement that servicing assets be amortized based on expected undiscounted cash flows. Paragraph A14 of FASB Statement No. 141, *Business Combinations*, indicates that servicing assets are intangible assets.

On balance, unless the Board decides to devote the time and energy necessary to comprehensively address amortization methodologies for intangible assets, we recommend that the observations in paragraph B12 be eliminated and the final FSP not address this issue. If the Board does decide to go forward with the guidance contained paragraph B12, we recommend that the guidance include a requirement that the amortization should be no less than straight-line amortization, similar to the guidance in FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, for capitalized computer software costs.

**Substantial Costs**

We recommend that the final FSP provide guidance with respect to “substantial costs.” We understand that it is not unusual for governmental entities to require enterprises that receive rights to provide services (for example, rights related to providing cable television, electricity, local television station broadcasts, and so forth) to agree to concessions as part of the granting or renewal of those rights (for example, the enterprise may agree to carry a local public access channel at no charge to the governmental entity, agree to bury electrical distribution lines that are currently above ground, or agree to begin broadcasting a high-definition television signal). Do such provisions create “substantial costs”? Should the enterprises consider expected incremental revenue, if any, associated with the concessions in making this determination?

**Impairment Testing of Renewable Intangible Assets**

Requiring an annual fair value impairment test for acquired renewable intangible assets in which a relatively small portion of the asset’s carrying amount is not currently being amortized seems to (1) create a significant difference in accounting for assets that, at the margin, are quite similar and (2) fail a cost/benefit analysis. Although any cutoff point will be arbitrary, we recommend basing the test on the “predominate” characteristic of the intangible asset. That is, if at acquisition, more than half of the value is assigned to the initial contract period (including reasonably assured renewals), apply the Statement 144 impairment standard. If at acquisition, more than half of the value is assigned to the portion of the intangible asset currently not being amortized, apply the Statement 142 impairment standard.

**Examples Contained in Appendix C**

We encourage the Board to retain the examples in the final FSP. However, we do have the following suggestions to improve the usefulness of the examples. First, we recommend that the examples explicitly state whether the renewal periods are or are not reasonably assured and that the examples include both renewal periods that are and that are not reasonably assured. Secondly, we recommend that a statement be added to the examples stating that the examples are not intended to provide any guidance with respect to the amortization method used to amortize the amounts within each identified period.

For your convenience, Attachment 2 contains a comparison of certain provisions of the proposed FSP to our suggestions above.

We thank you for considering our views. We would be pleased to discuss our comments with the Board or the FASB staff at your convenience.

Very truly yours,

Financial Reporting Advisors, LLC

## Amortization of Finite Lived Intangibles

32. The Working Group also discussed practice issues that arise in the determination of the pattern in which the economic benefits are consumed and whether that pattern can be reliably determined. The Working Group expressed concern about the pattern-of-economic-benefit approach (described below as Approach A) as a way of interpreting the phrase "pattern in which the economic benefits of the intangible asset are consumed or otherwise used up" from paragraph 12 of FAS 142. Therefore, the Working Group recommends an alternative approach (Approach B).

***Approach A: The pattern in which the economic benefits are consumed should be based on the cash flows generated by the intangible asset.***

33. Proponents of Approach A believe that, if the Task Force reaches a consensus on View A in Issue 3, Approach A is the only appropriate method to address the diminution in the value of an intangible asset caused by the risk of nonrenewal. Approach A proponents believe that the pattern in which the economic benefits are consumed further extends the concept that the useful life and fair value of an intangible asset, from an economic standpoint, are inextricably linked. Approach A (1) defines the "economic benefits" as the estimated cash flows to be generated by the intangible asset, (2) uses an amortization method that links the intangible asset's amortization to its undiscounted estimated cash flows, and (3) uses the period over which an intangible asset is projected to contribute to an entity's cash flows as the useful life of the intangible asset.

34. Opponents of Approach A observe that Approach A results in no amortization during periods in which the intangible asset is generating negative cash flows. Approach A opponents believe that nonamortization of an in-service intangible asset is inappropriate because the assets provide economic benefits even if the cash flows are negative.

***Approach B: The pattern in which the economic benefits are consumed should be based on the rights conveyed by the intangible asset.***

35. Approach B proponents generally focus on the rights conveyed by the intangible asset as the economic benefit rather than its cash flows. For example, assume that an entity acquires a technology licensing arrangement that conveys the right to produce and sell an unlimited quantity of product in exchange for a royalty. Approach B proponents believe that the entity's economic benefit is the right to produce and sell an unlimited quantity of product.[3] Approach A proponents, in contrast, believe that the economic benefit is the cash flows derived from the production and sale of the product (units of production).

[3] The licensee's production capacity may, for example, constrain their ability to produce and sell an unlimited quantity of product. The evaluation of whether the licensee's rights are constrained is based on the contractual rights conveyed by the intangible asset and *not* the licensee's production capacity.

36. In cases in which the intangible asset is placed in service[4] and is available for unconstrained output over a finite life, the economic benefit—unlimited availability over a fixed period of time—is consumed equally over time. Under this view, straight-line amortization is appropriate in situations in which the intangible asset provides the right to unconstrained output. In cases in which the intangible asset is placed in service and conveys the right to produce a finite quantity of product, the economic benefit—limited availability over a fixed period of time—is consumed as the product is produced.

[4] Supporters of Approach B analogize to Topic D-21 in order to determine when to begin amortization.

37. Proponents of Approach B cite paragraph B54 of FAS 142 to support their view.

> In considering the methods of amortization, the Board noted that Opinion 17 required that a straight-line method be used to amortize intangible assets unless another method was demonstrated to be more appropriate. However, the Board also noted that circumstances **may** exist in which another method **may** be more appropriate, such as in the case of a license that entitles the holder to produce a finite quantity of product. [Emphasis added.]

38. Proponents of Approach B also believe that the amortization of an intangible asset is analogous to the depreciation of tangible assets, and cite ARB 43, Chapter 9, Section C, paragraph 5.

> The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such *a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility*. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. [Emphasis added.]

39. Opponents of Approach B do not believe that straight-line amortization is generally appropriate, and cite paragraph B54 of FAS 142, which states that "the amortization method adopted should reflect the pattern in which the asset is consumed if that pattern can be reliably determined, with the straight-line method being used *as a default.*" [Emphasis added.]

40. The following example illustrates the difference between Approach A and Approach B.

> Company A acquires Company B and obtains an intangible asset that is available for unconstrained output over a six-year life. The intangible asset generates negative cash flows for the first three years and positive cash flows for the last three years. Approach A would result in the recognition of amortization during years four through six while Approach B would recognize amortization ratably over the six year period.

41. In other cases, Approach A and Approach B may produce similar results.

> Company A acquires Company B and obtains certain customer relationships. Company A's forecasted cash flows reflect a rapid dissipation of the relations in the earlier periods following the acquisition, with the rate declining over time until relatively few customers remain who persist for an extended period. Approach A would result in amortization according to the decline in cash flows that results from customer dissipation, resulting in more of the cost amortized in the earlier years of the intangible asset's useful life. Approach B would identify the rights conveyed by the customer relationship—the economic benefit—as (a) the information about the customer and regular contact with the customer and (b) the ability to make direct contact with the entity. These benefits are constrained since they provide Company A with limited availability (due to customer attrition) over a finite period of time. In this case, Approach B would amortize the customer relationship using an accelerated method of amortization.

**Attachment 2**

The following table assumes that the proposed FSP intended to allocate value to all renewal periods. As stated in our letter, we are uncertain if that is or is not the Board's intent.

| Renewal Assumptions | Proposed FSP | Suggested Approach |
|---|---|---|
| Acquired contract-based intangible asset with one reasonably assured renewal period. | Allocate fair value of the asset to (1) the initial contractual period of use and (2) the renewal period using discounted cash flows.<br><br>Amortize the amount attributed to the initial contractual period over the initial contractual period and amortize the amount attributed to the renewal period over the renewal period.<br><br>Test for impairment using the goodwill/indefinite lived impairment testing model. | No need to allocate fair value between the initial contractual period of use and the renewal period.<br><br>Amortize the fair value of the asset over its estimated useful life, which includes the one reasonably assured renewal period.<br><br>Test for impairment using the impairment model for intangible assets subject to amortization. |
| Acquired contract-based intangible asset with two renewal periods that are not reasonably assured. | Allocate fair value of the asset to (1) the initial contractual period of use and (2) each of the renewal periods using discounted cash flows.<br><br>Amortize the amount attributed to the initial contractual period over the initial contractual period and amortize the amounts attributed to each renewal period over the respective renewal periods.<br><br>Test for impairment using the goodwill/indefinite lived asset impairment testing model. | Allocate fair value of the asset to (1) the initial contractual period of use and (2) each of the renewal periods using fair values.<br><br>Same as proposed FSP.<br><br>If amount allocated to initial contract term exceeds 50 percent of total fair value, test for impairment using the impairment model for intangible assets subject to amortization.<br><br>If amount allocated to initial contract term is less than 50 percent of total fair value, test for impairment using the goodwill/indefinite lived impairment model. |

| Renewal Assumptions | Proposed FSP | Suggested Approach |
|---|---|---|
| Acquired contract-based intangible asset with one reasonably assured renewal period and two subsequent renewal periods that are not reasonably assured. | Allocate fair value of the asset to (1) the initial contractual period of use and (2) each of the renewal periods using discounted cash flows.<br><br>Amortize the amount attributed to the initial contractual period over the initial contractual period and amortize the amount attributed to each renewal period over the respective renewal periods.<br><br>Test for impairment using the goodwill/indefinite lived asset impairment testing model. | Allocate fair value of the asset to (1) the initial contractual period of use, including the reasonably assured renewal period, and (2) each of the renewal periods that are not reasonably assured using fair values.<br><br>Amortize the amount attributed to the initial contractual period (and the one reasonably assured renewal period) over the initial contractual period, including the reasonably assured renewal period, and amortize the amounts attributed to each renewal period that is not reasonably assured over the respective renewal periods.<br><br>If amount allocated to initial contract term, including the reasonably assured renewal period, exceeds 50 percent of total fair value, test for impairment using the impairment model for intangible assets subject to amortization.<br><br>If amount allocated to initial contract term, including the reasonably assured renewal period, is less than 50 percent of total fair value, test for impairment using the goodwill/ indefinite lived impairment model. |
| Acquired contract-based intangible asset with unlimited reasonably assured renewal periods. | No need to allocate fair value between the initial contractual period of use and the renewal periods.<br><br>Do not amortize the asset.<br><br>Test for impairment using the goodwill/indefinite lived asset impairment testing model. | Same as proposed FSP. |