

Recognition of Distribution Network Acquired in a Business Acquisition as an Intangible Asset

The following is the opinion given by the expert advisory committee of the institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. Company X (hereinafter referred to as the 'company') was incorporated in February 2011 as a wholly owned subsidiary of company Y. During the year 1st April, 2011 to 31st March, 2012, company X acquired a business from company Z, an unrelated party, on a slump sale basis for an arm's length consideration. Company Z is a leading manufacturer of kitchen appliances. The acquisition of business has led to company X becoming a leading player in this segment. As part of the acquisition, company X has acquired a large network of distributors, service centres, service points, retailers and manufacturing points.
2. The company operates through different channels, such as, the distributors, retailers, direct dealers, etc. More than 80% of the sales in the past were effected through the network of distributors (hereinafter referred to as 'the distribution network').
3. The management of company X engaged a valuer to carry out the purchase price allocation. The intangible assets identified by the valuer for the purchase price allocation included brands and the distribution network. As per the valuation report, the distribution network was identified as an intangible asset based on the following assumptions:
 - a) Around 80% of the revenues in the financial year 2011-12 will be derived through the distribution network and that contribution of current and new distributors would reduce from 80% to 70% over the 10 year explicit forecast period in a linear fashion. For valuing distribution network, only projected revenues from existing distributors were considered.
 - b) The knowledge and relationships of the distributors matter significantly in the industry and a new market entrant may not be able to replicate the same easily. In this aspect, the distribution network seemed to have a distinct advantage over those of other market intermediaries. Considering the time period over which the current distributors are expected to contribute to the revenues of company X, the economic life of the distribution network was considered to be indefinite.
4. The following are the key terms of the distributor agreement:
 - a) The agreement appointing the distributor is valid till 31st March, 2012 and is renewable on mutual terms. Thus, if not renewed, the distributor agreement will apply for company X from the date of acquisition of business until 31st March, 2012.
 - b) The authorised distributor cannot market or deal with any other similar product directly or indirectly (either imported or indigenous).
 - c) If the distributor owns/operates any retail counters, such retail counters shall deal only with the company's brand at least in MG (a particular type of product) category. The distributor will take the company's prior written approval before dealing in the products of any other brand.
 - d) In keeping with the company's plans for expansion in other product categories, it is expected that the distributor will assign the inputs and focus as directed by the company to these products in their respective markets' retail counters.
 - e) The appointment of distributorship can be terminated by either party on 30 days' written notice without assigning any reason. In the event of unsatisfactory performance, misconduct, misbehaviour or negligence or

- loss to the company, or any material breach of any of the terms of this agreement by the distributor, as may be opined and determined solely by the company at its discretion, the appointment may be terminated by the company forthwith.
- f) The appointment granted herein to the distributor is entirely personal and non-assignable by the distributor. The distributor shall not be entitled or permitted to transfer the appointment for authorised re-distribution of the company's products to any other person, party or company in any manner whatsoever, without the express consent of the company as received in writing.
 - g) In order to maintain the company's brand value and goodwill, the company's suggested pricing while making supplies by the distributor to its sub-dealers, should be maintained in order to avoid underselling, which will lead to erosion of margins, brand image and sales. The company shall have the right to terminate this agreement in the event of violation of this clause.
 - h) A distributor is appointed for a specified district only. Infringement by way of supplying to any other territory will lead to termination of appointment with immediate effect.
 - i) The company at its discretion may effect direct supplies to the existing network of dealers or new dealers in the above area.
5. As per the querist, each year there is movement in the number of distributors covered under the network, but the distributors terminated are replaced by new distributors in their respective regions besides distributors being appointed for new regions. Thus, the turnover foregone because of the decrease in the number of the distributors is effectively replaced by appointment of new distributors who are also subject to the same terms and conditions. It is reiterated that purchase price allocation done by the valuer is only for existing distributors.
 6. The following facts are also relevant:
 - During the period ended 31st March, 2012, sales made through the distributors were 85% of total sales.
 - The percentage of distributors appointed during the past 3 years is around 24% and that of those terminated is around 11%. The
 - loss of revenue caused due to termination is 0.32% of total gross turnover, while the revenue generated by new distributors is 8%.
 - In most cases, the termination of distributors is on account of their financial disability or due to dispute in their organisational structures.
 7. The querist has separately informed that the total number of authorised re-distributors was 105 as on 31st March, 2012 and, subsequently, there were 6 additions and 6 discontinuances till October 2012. Thus, the probable rate of discontinuance is around 6%. However, an equal number of authorised re-distributors have been appointed during the period from April 2012 till October 2012.
 8. The brand has been in existence for more than 10 years which gives added advantage over the other competitors and thus, makes it highly unlikely for the distributors to quit the dealership of the company.
 9. The accounting issue that arises is whether the existing distribution network can be recognised as an intangible asset when accounting for acquisition of company Z's kitchen appliances business by the company X.
 10. The querist has drawn the attention of the Committee to the following paragraphs of Accounting Standard (AS) 26, 'Intangible Assets':
 - “6.1 An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.***
 - 6.2 An asset is a resource:***
 - (a) controlled by an enterprise as a result of past events; and***
 - (b) from which future economic benefits are expected to flow to the enterprise.”***
 - “Identifiability**
 11. The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. Goodwill arising on an amalgamation in the nature of purchase represents a payment made by the acquirer in anticipation of future economic benefits. The future economic benefits may result from synergy between the identifiable assets acquired or from assets which, individually, do not qualify for recognition

in the financial statements but for which the acquirer is prepared to make a payment in the amalgamation.

12. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

13. Separability is not a necessary condition for identifiability since an enterprise may be able to identify an asset in some other way. For example, if an intangible asset is acquired with a group of assets, the transaction may involve the transfer of legal rights that enable an enterprise to identify the intangible asset. Similarly, if an internal project aims to create legal rights for the enterprise, the nature of these rights may assist the enterprise in identifying an underlying internally generated intangible asset. Also, even if an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

15. Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.”

”17. An enterprise may have a portfolio of customers or a market share and expect that, due to its efforts in building customer relationships and loyalty, the customers will continue to trade with the enterprise. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the enterprise, the enterprise usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets.

Future Economic Benefits

18. The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Recognition and Initial Measurement of an Intangible Asset

19. ...

20. An intangible asset should be recognised if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) the cost of the asset can be measured reliably.

21. An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

22. An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.

23. An intangible asset should be measured initially at cost.”

11. As per the querist, the extracts from AS 26 reproduced in paragraph 10 above show that an intangible asset should have the following characteristics:

- Identifiability - an asset should be separable, i.e., capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability;
- Control over the resource - in order to demonstrate control, an entity must have the power to obtain the future economic benefits arising from the item and be able to restrict the access of others to those benefits;
- Existence of future economic benefits – an intangible asset should be expected to give rise to future economic benefits, e.g., in the form of revenue from the use of the asset;
- No physical substance; and
- Non-monetary.

12. The fact whether distribution network acquired in the present case pursuant to business acquisition can be recognised as an intangible asset by the buyer should be determined by applying the above principles. As per the querist, this involves determining whether the distribution network meets the criteria of identifiability, control and future economic benefits such that it qualifies for recognition as an intangible asset. Further, as per the querist, the following points are noteworthy in this regard:

- The relationship between the company and distributors is governed by an agreement with each distributor which clearly spells out the rights and obligations of each party.
- The distributor cannot market or deal with any other similar product directly or indirectly.
- The pricing suggested by the company should be followed while making supplies to the sub-dealers. In case of violation, the company has the right to terminate the agreement.
- The appointment granted to the distributor is specific and non-assignable by the distributor.
- The retail counters of the distributor shall deal only with the company’s brand at least in MG category. Prior written approval of the company is required before dealing in the products of any other brand.

- The distributor is expected to assign the inputs and focus as directed by the company to these products in its respective retail counters.

13. As per the querist, considering the above, it can be concluded that the criteria of identifiability and future economic benefits are met. The question, then, is whether the control criterion is met. On this issue, there can be the following two views:

View 1

One view can be that the agreements with distributors provide control over the distribution network only for a very limited period of time. This view is based on the reasoning that–

- the agreement appointing each distributor was valid only till March 31, 2012 and it was renewable only with mutual consent and not unilaterally by the company;
- the agreement can be terminated by either party on 30 days’ written notice without assigning any reason. Thus, beyond this notice period, neither party has any legal rights or remedies against the other party.

The above aspects of the agreement indicate that at the time of acquisition of relevant business from company Z, company X acquired ‘control’ over the distribution network only for the non-cancellable period of distributor agreements, i.e., for a period of 30 days only. The continuance of the distributorship beyond this period was at the discretion of the distributors and, hence, was not within the control of the company. Consequently, the value to be placed on the distribution network should be with reference to this period. Given that the period is very small, it seems that distribution network will not have any significant value. The valuer has taken the useful life of distribution network as indefinite and on this basis ascribed a significant value to the distribution network. However, in the absence of any legal right, the company does not have any control over the network beyond the non-cancellable period of 30 days. The mere fact that historically, only a small percentage of distributors has exited does not mean that the company has control over the distributors – each of whom is free to leave after 30 days. Hence, only a very small value (corresponding to non-cancellable period) can be ascribed to distribution network as a separate intangible asset.

View 2

A contrary view can be that where an entity acquires any right from another party in an arm’s length

transaction, it is implicit that the entity expects future economic benefits to arise from the right and it pays for the same on the basis that it has implicit control to ensure that those benefits flow to it. To conclude that control does not exist unless contractual or legal rights are present would not reflect the substance of the situation. If control in some way was not present, the purchase of the right would just not make commercial sense. This position is clearly recognised in paragraph 16 of International Accounting Standard (IAS) 38, 'Intangible Assets', as below:

"16. ... In the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the expected future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset."

In this regard, it may be noted that the concept of what constitutes 'control' is the same under both IAS 38 and AS 26 as is evident from the following extracts from these standards:

Extract from IAS 38

"13. An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way."

Extract from AS 26

"14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence

of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way."

The portion of paragraph 16 of IAS 38 reproduced above was included in the revised version of IAS 38 and, as per the Basis for Conclusions on IAS 38, this inclusion is intended to 'clarify' the position. AS 26 is based on pre-revised IAS 38 and, hence, it does not contain this portion.

Extracts from Basis for Conclusions on IAS 38

"BC13 The Board observed that exchange transactions for the same or similar non-contractual customer relationships provide evidence not only that the item is separable, but also that the entity is able to control the expected future economic benefits flowing from that relationship. Similarly, if an entity separately acquires a non-contractual customer relationship, the existence of an exchange transaction for that relationship provides evidence both that the item is separable, and that the entity is able to control the expected future economic benefits flowing from the relationship. Therefore, the relationship would meet the intangible asset definition and be recognised as such. However, in the absence of exchange transactions for the same or similar non-contractual customer relationships, such relationships acquired in a business combination would not normally meet the definition of an 'intangible asset'—they would not be separable, nor would the entity be able to demonstrate that it controls the expected future economic benefits flowing from that relationship.

BC14 Therefore, the Board decided to clarify in paragraph 16 of IAS 38 that in the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset."

Besides having the same concept of 'control', both AS 26 and IAS 38 also explicitly recognise that legal

rights are not the only way of acquiring control and that an enterprise may be able to control the future economic benefits in some other way also. Based on a combined reading of AS 26 and IAS 38, it can be argued that the explicit assertion in IAS 38 that standalone exchange transactions of non-contractual customer relationships provide evidence of control is a clarification of what, in the absence of legal rights, the other ways of controlling future economic benefits can be. On this basis, it can be argued that the distribution network can be recognised as an intangible asset, if there are exchange transactions for such networks (other than as part of business combinations). The querist has separately informed that the distributors who left the company would probably join other competitors for their products but the querist is not aware of any specific market where distribution network is exchanged.

B. Query

14. The querist has sought the opinion of the Expert Advisory Committee as to whether the distribution network acquired as part of the business acquisition in the extant case qualifies for recognition as an intangible asset as per AS 26.

C. Points considered by the Committee

15. The Committee notes that the basic issue raised by the querist relates to initial recognition of the distribution network acquired as part of the business acquisition as an intangible asset as per Accounting Standard (AS) 26, 'Intangible Assets'. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, valuation of the distribution network, subsequent recognition of 'distribution network' as an asset once the contract with the distributor expires on March 31, 2012, detailed aspects of initial accounting of the business acquisition, recognition of other assets and liabilities acquired as a part of business acquisition, treatment of expenditure, if any, incurred on addition of new distributors to the acquired distribution network, etc. Incidentally, the Committee notes that the 'economic life' of the distribution network is assumed to be indefinite as per valuation report (see paragraph 3(b) above), whereas, the querist has stated in paragraph 13 (see View 1) that the valuer has taken the 'useful life' of distribution network as indefinite. The Committee wishes to point out that terms 'economic life' and 'useful life' are different, though, as a matter of

coincidence, the economic life and useful life of an asset may be same in some situations. Further, as a passing reference, the Committee wishes to point out that for *accounting* purposes, the concept of intangible assets with indefinite life is found in IAS 38 and not in AS 26. However, these matters do not affect the opinion of the Committee.

16. The Committee notes that in the extant case, distribution network is acquired as a part of acquisition of kitchen appliances business. The Committee notes paragraph 31(a) of AS 26 as given below:

“(a) a transferee recognises an intangible asset that meets the recognition criteria in paragraphs 20 and 21, even if that intangible asset had not been recognised in the financial statements of the transferor;...”

In view of the above, the Committee is of the view that for recognition, an intangible asset, even if acquired as part of a business purchase, should meet both the definition and recognition criteria specified in AS 26, reproduced by the querist in paragraph 10 above. The Committee notes from the Facts of the Case that the distribution network, being an arrangement for the marketing of the company's product, is a non-monetary item without physical substance held for the purpose of supply of goods. Further, it appears from the Facts of the Case, that the existence of the distribution network is a factor for the acquisition of the business. Also, while allocating the purchase consideration, the valuer is able to identify the distribution network separately and also assign a value to it. This indicates that (i) the distribution network is identifiable; (ii) it is probable that future economic benefits attributable to the distribution network will flow to the company; and (iii) the cost of acquisition of the distribution network can be measured reliably. Further, as regards 'control', the Committee notes paragraphs 14 and 17 of AS 26 as reproduced below:

“14 An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control since an

enterprise may be able to control the future economic benefits in some other way.”

- “17 An enterprise may have a portfolio of customers or a market share and expect that, due to its efforts in building customer relationships and loyalty, the customers will continue to trade with the enterprise. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the enterprise, the enterprise usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets.”

The Committee is of the view that the key terms of the distribution agreement mentioned by the querist in paragraph 4 above indicate that the distribution network is controlled by the company at the time when it acquires the business. However, the Committee also notes that the distribution agreement is valid only upto March 31, 2012 and as stated by the querist, the exchange (market) transactions for the same or similar distribution network are not available. In other words, there does not appear to be any control on distribution network either through legally enforceable rights or in any other way beyond March 31, 2012. Accordingly, the Committee is of the view that the company has control over the distribution network upto the validity of the distribution agreement, i.e. upto March 31, 2012. Hence, the distribution network acquired as part of the business acquisition meets both the definition and recognition criteria (although for short period of time), as specified in AS 26, reproduced by the querist in paragraph 10 above.

Incidentally, the Committee wishes to mention that for initial recognition of distribution network it is not necessary to examine the relevance of clarificatory amendment to paragraph 16 of IAS 38 mentioned by the querist in paragraph 13 above, especially, when that amendment is applicable in the context of absence of legal rights, whereas, in the extant case, there is transfer of legal rights arising from the distributor agreement in favour of the company. Further, the Committee notes that the querist’s view mentioned in paragraph 11 above gives an impression that identifiability criterion is met only if the intangible asset is separable. This is not correct, since, as per paragraph 13 of AS 26 reproduced by the querist in paragraph 10 above, separability is not a necessary condition for identifiability.

17. The Committee is further of the view that if, after applying an appropriate valuation technique, distribution network is not considered as a ‘material’ item, the company may choose either to recognise the distribution network as an intangible asset at an immaterial value or not to recognise it as an intangible asset. This is because ‘materiality’ is one of the considerations in selection of accounting policies as per paragraph 17 of Accounting Standard (AS) 1, ‘Disclosure of Accounting Policies’. Further, as per paragraph 4.3 of ‘Preface to the Statements of Accounting Standards’ issued by the Institute of Chartered Accountants of India, Accounting Standards are intended to apply only to items, which are material. A material item is described as an item, the knowledge of which might influence the decisions of the user of the financial statements (see paragraph 17(c) of AS 1).

D. Opinion

18. On the basis of the above, the Committee is of the opinion that the distribution network acquired as part of the business acquisition in the extant case qualifies for recognition as an intangible asset as per AS 26 only upto March 31, 2012, as discussed in paragraph 16 above. As regards materiality considerations, see paragraph 17 above.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on May 21-22, 2013. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty one volumes. A CD of Compendium of Opinions containing thirty one volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head ‘Resources’.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head ‘Resources’. For further information, write to eac@icai.in

