AN OPPORTUNITY FOR VALUATORS

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On June 29, 2001, FASB altered the traditional approach of the North American corporate finance community by introducing a forest of new rules covering accounting for Mergers & Acquisitions (business combinations); a substantially similar version will soon be introduced in Canada.

Pooling is out. Purchase accounting is in and is now the only way, but it is not the purchase accounting we learned in school. Full details will be set out in two new FASB Statements planned for later this summer: No. 141 will cover "Business Combinations", while No. 142 will deal with "Other Intangible Assets".

This new regime is well described in the Exposure Draft of February 14, 2001, and the FASB Decisions released July 6. The time to plan for this is now.

Separation of Identifiable Intangible Assets

The new rules apply to business combinations completed after July 1, 2001, and to all companies for their fiscal years commencing after December 15, 2001. As a result, the current figure for goodwill will no longer appear on the Balance Sheet. Every Identifiable Intangible Asset, such as licenses, patents, trademarks and proprietary software must be defined, valued, and amortized over its economic life; these periods are usually much shorter than up to the 40 years commonly applied to goodwill.

According to FASB, an intangible asset acquired in a business combination will be recognized as an asset apart from goodwill (Identifiable Intangible Asset), if it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the acquired enterprise, or from other rights and obligations. If an intangible asset does not arise from such rights, it shall be recognized as an Identifiable Intangible Asset only if it is capable of being separated or divided from the acquired enterprise, and sold, transferred, licensed, rented, or exchanged, even if there is no intent to do so, either on its own or with a related contract, asset, or liability.

After the amounts for each Identifiable Intangible Asset have been deducted from the goodwill, the residual is the new Goodwill; this, by definition, will also include the "value of the assembled workforce of at-will employees acquired in a business combination". A company will no longer be required to amortize Goodwill, but the carrying amount on the Balance Sheet must pass an "Impairment Test" at least annually; in addition some Identifiable Intangible Assets with long lives, such as trademarks and customer lists must be tested for impairment .

Basic Approach

The Basic Approach is:

- Dividing the company's operations into two or more Reporting Units;
- Allocating the purchase prices of past acquisitions with existing goodwill to those Units; and
- Defining and valuing all Identifiable Intangible Assets so that they can be deducted to give the residual Goodwill for each Unit.

This process is likely to create significant opportunities for experienced business appraisers.

Impairment Test

The Impairment Test, which is to be applied separately to the Good-will for each Reporting Unit, has three stages:

1. Determine the "Fair Value" (defined below) of every Reporting Unit;
2. Calculate the Book Value, including the amortized Identifiable Intangible Assets and Goodwill, for each Unit and compare it with the Fair Value;
   If the Fair Value exceeds the Book Value, there is no impairment, and the Goodwill remains unchanged on the Balance Sheet. If the Book Value exceeds the Fair Value, the third stage must be applied:
3. Establish the implied Fair Value of the Unit's Goodwill.
   If the Book Value of the Goodwill exceeds its implied Fair Value, the excess is the" impairment loss" that must be recognized.

The implied Fair Value of the Goodwill is calculated in the same manner as goodwill is determined in business combination accounting according to APB (Accounting Principles Board), Opinion 16. In this complex process, the Fair Value of the Reporting Unit is allocated to all its assets and liabilities, including any unrecognized intangible assets, as if it were the purchase price of the Unit.

The excess of the "purchase price" over the amounts assigned to the assets and liabilities is the implied Fair Value of the Goodwill. This allocation is used only to test the Goodwill for impairment and does not require any change in the reporting of any other as-sets or liabilities.

One problem with these new rules is that write-downs of Goodwill due to impairment are likely to generate a lot more negative reaction in the stock market than the present amortization charges, which were often ignored by financial analysts and investors.

Nature of Fair Value

The definition of Fair Value proposed by FASB is set out below. It is similar to the standard definition of Fair Market Value, but differs enough to be potentially troublesome:

> "The Fair Value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."

The Impairment Test must be applied at least once a year at the same date, and on an interim basis if something occurs that might reduce the Fair Value of the Reporting Unit. The Impairment Tests do not have to be at the same time for all the Reporting Units; therefore, there is an opportunity to spread the work out by dealing with different Units at different times throughout the year.

Reporting Units

One very important task in applying the new rules is in the choice of the Reporting Units. Those are to be at "the same level as, or one level below an Operating Segment, as that term is used in FASB Statement No. 131, 'Disclosures about Segments of an Enterprise and Related Information'."

The SEC is sure to have a field day when it reviews the first audited statements filed by companies under the new rules. It is highly likely that they will focus on two areas, Reporting Units, and the allocation of the purchase prices of past acquisitions.

Most public companies have satisfactory reporting systems to show the results of the various Operating Segments; the "segment level" is therefore reasonably familiar to their accounting staff, even though the SEC sometimes requests additional separation, but in the past, private companies never had to do this. Now they will all have to create Reporting Units that may also be "one level below the Operating Segments".

Does this mean additional segregation by geography, technology, products or customers, or something completely different? Even after the final FASB Statements are published, deciding on what activities are actually to be included in each Reporting Unit will be a complex matter, requiring management, auditor and valuator working together. A golden middle must be found to obey the rules, yet serve the firm.

In the end, a Reporting Unit may consist of a mixture of one or more of the following: divisions of the parent, its domestic subsidiaries, divisions of foreign subsidiaries, partially owned firms, partnerships and joint ventures. To obtain results that the SEC will accept, it appears likely that each operating entity will have to be valued separately.

Management Attitudes

Intangible assets are soft and fuzzy; for a CPA trained to like assets hard and well defined, they can be disconcerting. Some of them in industry are concerned about the accuracy of current re-

porting models, which only record acquired intangibles; they also fear divulging competitive information, which means there is a tendency to limit disclosure.

The same factors apply to an even greater degree to internally developed intangibles. Attempting to isolate and value the intangible assets of companies may be counterproductive, according to the Brookings Institution (a Washington think tank):

> "Overall company value is driven by a host of interactive decisions and activities.... and any attempt to desegregate this overall value into individual intangibles would result in arbitrary measures."

For example, the value of a brand name depends on such variables as "product quality, price, distribution channels, dealer relation-ships, and other factors." The Institution considers that a brand name's contribution to overall corporate value depends on how well management integrates it with other elements of the business. In other words, trying to separate the value of the Coca-Cola brand name from the other assets that contribute to and benefit from it is to them a meaningless exercise.

Allocation of Purchase Prices

The allocation of the purchase prices of previous acquisitions, the determination of their Identifiable Intangible Assets and hence the unamortized Goodwill of the various Reporting Units is a source of potential problems for Auditors; it could give management opportunities for shenanigans similar to those that occurred with one-time-charges.

In some cases, after a bad quarter or poor year, management takes a "big bath" to "clear the decks" and remove some "bad stuff" from the Balance Sheet. When this happens, not only do future profits appear greater, but the Return-on-Equity jumps substantially as the numerator (profits) is higher and the denominator (equity) lower. Some commentators expect that managements will be tempted to follow that path when dealing with the Impairment Test.

Assume a business has the minimum two Reporting Units, one of which is doing well and the other poorly; management will no doubt lean towards assigning as much Goodwill as possible to the one that is doing well, as its Fair Value is likely to increase, thereby avoiding any impairment loss in the near-term.

On the other hand, a loss as a result of the initial Impairment Test can be treated as a change in accounting principles. Instead of risking significant write-downs in the future, management might allocate as much Goodwill as supportable against the poorly performing Unit and present the impairment loss in the first fiscal year as an accounting change.

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The value of the Identifiable Intangible Assets must be amortized over their useful life, while Goodwill only requires meeting the Impairment Test; therefore, there is some concern that managements may undervalue the Identifiable Intangible Assets in the purchase price allocation so as to reduce the amortization charges.

Taxation

The new FASB accounting rules for Goodwill and Identifiable Intangible Assets will have no impact on their tax treatments. Before the addition in 1993 of Section 197 to the Internal Revenue Code ("IRC"), goodwill and most other intangible assets arising from an acquisition could not be amortized for tax purposes. Section 197 stipulates that intangible assets acquired as part of a transaction taking place after August 10, 1993 must be amortized over fifteen years. It also states that the excess of the purchase price over the total Fair Market Values of both tangible and intangible assets less liabilities (referred to as "acquisition goodwill") must also be amortized over fifteen years for tax purposes.

Determining Fair Value

In establishing Fair Market Value for assets, three standard approaches, Cost, Market and Income are normally used. For Identifiable Intangible Assets, there is the same choice with some limitations.

Cost

In general, the value of intangible assets is not related to their cost. A firm's technology, for example, lies not its R&D efforts, but in their results. For that reason, R&D expenditures are not useful as a measure of a company's technological intangible assets, such as patents. Similarly, costs incurred to train employees or advertise to acquire new customers are poor indicators of the value of the related Identifiable Intangible Assets. The two areas where we have found the cost approach useful in establishing value are: the reproduction costs of internally generated computer software, and creating a trained work force; the latter now forms part of Goodwill.

Market

The FASB decision gives some guidance in establishing Fair Value by the market approach:

> "The fair value of a reporting unit refers to the amount at which the unit as a whole could be bought or sold in a current transaction between willing parties. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. How-ever, the market price of an individual share of stock (and thus the market capitalization of a reporting unit with publicly traded stock) may not be representative of the fair value of the reporting unit as a whole. Therefore, the quoted market price of an individual share of stock need not be the sole measurement basis of the fair value of a reporting unit."

Alas, there are few sales of solely intangible assets; most are multi-asset transactions that include tangible items. Comparability is therefore critical. An effective means of employing this approach is the relief-from-royalty method.

Income

The income approach is the most common for intangible assets; two of its methods are discussed in the FASB decision. The first is the net income method, on which it comments as follows:

> "If a quoted market price of the shares of a reporting unit is not available, the estimate of fair value should be based on the best information available, including prices for similar assets and liabilities and the results of other valuation techniques. A valuation technique based on multiples of earnings, revenue, or a similar performance measure may be used to estimate the fair value of a reporting unit if that technique is consistent with the objective of measuring fair value. Use of multiples of earnings or revenues in determining the fair value of a reporting unit may be appropriate, for example, when the fair value of an entity that has comparable operations and economic characteristics is observable and the relevant multiples of the comparable entity are known. Conversely, use of multiples would not be appropriate in situations in which the operations or activities of an entity for which the multiples are known are not of a comparable nature, scope, or size as the reporting unit for which fair value is being estimated."

One of the most difficult tasks is determining the amount of re-venue or income that can be generated by any particular asset. This can be done either "top-down" by allocating the total economic benefits between all the assets, or "bottom-up" by specifically identifying the economic benefits derived from the asset.

The second income method discussed by FASB is Discounted Cash Flow, on which it comments as follows:

> "A present value technique is often the best available technique with which to estimate the fair value of a group of assets (such as a reporting unit). If a present value technique is used to measure fair value, estimates of future cash flows used in that technique should be consistent with the objective of measuring fair value. Those cash flow estimates should incorporate assumptions that marketplace participants would use in their estimates of fair value whenever that in-formation is available without undue cost and effort. Other-wise, an entity may use its own assumptions. Those cash flow estimates should be based on reasonable and supportable assumptions and should consider all available evidence. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for the amounts or timing of cash flows, the likelihood of possible outcomes should be considered."

Finally, FASB refers to FASB Concepts Statement No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements", which sets out the essential elements of a Fair Value measurement, provides examples of circumstances in which an entity's cash flows might differ from the market cash flows, and discusses the use of present value techniques in measuring the Fair Value of an asset or a liability.

Role of the Valuator

There is a negative side to this opportunity - the fact that valuators have to familiarize themselves thoroughly into a whole new set of rules and regulations - and a positive one, namely that rather nice fees can be charged for such undertakings.

FASB has blessed us with a publication which so far encompasses some 54 pages in the Exposure Draft, with another 100 or so still to come in the two statements. That will be the original document, with amendments and commentary certain to follow like the amen in the prayer.

None of this is going to be easy. Intangible assets tend to re-quire definition on a case-by-case basis, and it is essential to avoid any suggestion that the values are in any way the subjective views of the valuator. While most auditing firms have some valuation capabilities, they should look to experienced and reputable specialists to work with them in setting up the Reporting Units and valuing the Identifiable Intangible Assets. Besides, if you hire accountants specializing in valuations, there is little likelihood that your other business, such as ongoing accounting and tax work, would be poached.

Another essential item is to select an appropriate methodology, which will undoubtedly vary from asset to asset and from country to country, depending on the availability of industry information and benchmark data.

As there are no precedents for establishing the Fair Value of the various Identifiable Intangible Assets, it is most important to keep much more detailed documentation than for normal valuation engagements. It is highly likely that any public company's decisions, actions and methodologies will be questioned by the regulatory authorities, and perhaps tested in a court of law. While private companies will be free of regulatory oversight, they are also subject to the possibility of law suits by disgruntled share-holders.

Render unto Caesar the things which are Caesar's, but don't forget to look after your own hide.

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