BUSINESS COMBINATIONS, INTANGIBLE ASSETS AND GOODWILL

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INTRODUCTION

Five years ago, on Friday, May 29, 1998, I had the honor and privilege of addressing the NACVA National Conference in Washington D.C.; the subject then was "The Year 2000 Millennium Bug". Fortunately, thanks to a lot of hard work by many dedicated computer specialists who paid attention to the innumerable dire predictions, the world managed to pass through that crisis unscathed.

Today I'll be talking about - well, not a crisis, but an event that may have a similar impact, of almost revolutionary character, and with a much greater long-term effect on our profession.

It concerns FASB's 2001 Statements of Financial Accounting Standards ("SFAS") 141, 142 and 144, which relate to Business Combinations, Intangible Assets, Goodwill and Goodwill Impairment. These go hand in hand with the 2002 legislation by Congress, the Sarbanes-Oxley Act, which will be dealt with by my friend and collaborator, Salty Schumann. Salty, my partner Dita Vadron and I are writing a book on "Fair Value for GAAP", which will cover in detail the implementation of SFAS 141, 142 and 144; it will be published by NACVA this fall and, we hope, will give you and other professionals as well as students appropriate guidelines as to what needs to be done. By the way, the concept of "guidelines" will be much mentioned in the book. Fair Value is becoming more and more important in GAAP, and is an integral part of a number of other FASB Standards.

How Important is this Subject?

Thanks to Dean Dinas of CEIR, who is able to obtain for a valuation analyst nearly any fact that is available or might be somewhere out there, we can offer some data.

According to Standard & Poor's, based on the 10-K forms filed with the SEC, as of April 24, 2003, the US companies in their indices had total 2002 Goodwill Impairment losses of $115 billion; of this, AOL alone amounted to $30 billion. The overall figure does not include an estimated $150 billion of transitional Impairment Losses classified as "charges due to accounting changes"; of this latter amount, AOL's share represented a further $54 billion, JDS Uniphase's $50 billion and Qwest's $23 billion.

To put this total of $265 billion into perspective, the S&P 1500 Index (their broadest) for 2002 had GAAP earnings (after Impairment Losses) of merely $557 billion. In other words, SFAS 141, 142 and 144 reduced GAAP earnings by nearly a third, which in many circles is viewed as coming much closer to reality.

Bloomberg, a New York financial information service, thriving even after the departure of its founder to run this wonderful little town, estimates that aggregate 2002 write-offs, including Goodwill, Intangible Assets and restructuring charges for all US public companies are around $750 billion. Lehman Brothers, a Wall Street firm where I once worked, predicts that 2003 write-offs will amount to a further $200 billion. Therefore, in the first two years of the new regime close to one trillion dollars will have been written off by public companies. The thought comes to mind as to where all this money went, but, after all, it was only paper to begin with. I am told that in the Roaring Twenties, in certain circles, cigars were being lit with hundred dollar bills.....

What's Left?

We know of no database that gives a total for the amount of Goodwill left on US Balance Sheets, but it is obviously still enormous. For example, twelve large US organizations each have a total of Intangible Assets and Goodwill in excess of $20 billion.

	Goodwill	Intangible Assets	Total
AOL Time Warner	37	44	81
Comcast	17	54	71
Viacom	57	12	69
General Electric	-	46	46
Altria	26	12	38
Citigroup	27	8	35
Tyco	26	7	33
American Int. Group	6	22	28
Berkshire Hathaway	22	-	22
Clear Channel	7	13	20
Disney	17	3	20
Hewlett Packard	15	5	20
	257	226	483

Based on the 10-K filings, the 50 companies with the largest recorded Goodwill (over $6 billion each) have a total of $739 billion still remaining to be dealt with. Intangible Assets are similarly large, but again, no exact figures are available; on the basis of the twelve organizations listed above, we estimate that those 50 firms would have Intangible Assets of about $650 billion.

Impact on Investors

From the beginning of 1995 to a peak in June 2000, the S&P 500 Index had a compound annual growth of 23%. Over the same period, its GAAP earnings increased only 10% a year; this was far above the average annual profit gain of 6.6%, from 1948 to 1994. Some observers believe the enormous write-offs of 2002 mean that, to some extent, the corporate profit "miracles" of the late 1990s resembled more a mirage! This view is supported by the confusion among analysts and investors regarding the spate of impairment and restructuring charges. If some of today's impairments are, in effect, reductions of past profits, what figure does one use in calculating a Price/Earnings Ratio? I personally prefer operating profits before Income Taxes; this is a key indicator for Existing Operations. Which do you use?

Wall Street, where I worked over forty years ago, has placed revenue and earnings growth on a pedestal. Therefore many investors are bidding up the shares of companies, which have taken large write-offs, in effect, rewarding them; this is because they consider the charges as bad news that has been laid to rest, allowing higher future growth. Do you agree?

What Has to be Done?

Much of the Goodwill and Intangible Assets on current Balance Sheets arose as a result of transactions at PERs well above those of today. For example, in December 1999, a simple average of the S&P 500 Index PERs was 33.5; by February 2003, it had declined 60% to 13.4. This suggests that any acquisition since about 1995 (the last time PERs were in the current range) led to Goodwill that might be impaired.

While it takes some studying and work, applying SFAS 141, 142 and 144 provides lenders, investors and managers with important information. They eliminate bloated assets and assist in evaluating the results of management decisions. No longer does the impact of a bad acquisition bleed the income statement forever, as was the case when goodwill was amortized over forty years.

All publicly traded companies have adopted SFAS 141, 142 and 144, and their auditors are carefully checking compliance of their Financial Statements with GAAP. The same cannot be said for many private companies, whose compliance is generally poor. It seems almost a case of déjà vu, as preparing for the millennium bug produced a similar lagging behind in that sector.

Regardless of whether your client's company is public or private, GAAP applies. If there are any Intangible Assets or Goodwill, the Impairment Test MUST be applied to its Financial Statements. I hate to tell you this, but, as a matter of fact, this procedure should have been set in motion for fiscal years ending in 2002.

Situation for Private Companies

Regrettably, although SFAS 142 is now an integral part of GAAP, it is being ignored by many CPAs who serve privately-held companies; this may violate professional obligations. In light of the huge write-offs reported by public companies, there is a very real possibility material Goodwill write-downs will also be necessary among some of your privately owned clients.

When a business is sold, a normal representation is that the Financial Statements are prepared in accordance with GAAP.

Can your clients say this with complete assurance and responsibility?

Commercial loan agreements generally require periodic submissions of GAAP Financial Statements to the lender. Without an annual Goodwill Impairment Test your client is likely breaching this covenant.

Loans also often require the borrower to meet financial tests based on GAAP statements; this means a Goodwill Impairment Loss may result in a technical default. If such a test is not undertaken and losses occur, the lender may claim damages against the CPA, alleging that the accounting failure was so great as to indicate a purposeful hiding of the truth. Executives and professionals involved with such Financial Statements could be held personally responsible.

Obviously, we all try to ensure that every Audited or Reviewed Financial Statement that comes out of our offices is in accordance with GAAP. One problem is that SFAS 141, 142 and 144 have not always been implemented.

I am often asked:

> "Can we do the valuation for a Goodwill Impairment Test of private companies internally?"

My answer is:

> "I would not like to defend myself in court for providing a service to a private company that, under the Sarbanes-Oxley Act, I cannot legally do for a publicly traded entity".

Background to the Standards

In this session, as well as in our upcoming book, we are mainly dealing with three of the FASB Standards, 141, 142 and 144.

SFAS 141 "Business Combinations"

Under APB 16 "Business Combinations", issued in 1970, both the purchase and pooling of interests methods could be used to account for mergers and acquisitions. However due to the "dirty Pooling" problems of the 1960s conglomerate mergers, the rules covering Pooling were complex and consistently a major source of irritation for both practicing CPAs and the SEC staff.

SFAS 141 eliminates Pooling and thereby puts the United States on the same basis as most of the rest of the world; however, it modifies the Purchase Method by:

- Rules to identify the Purchaser (there has to be one!)
- Establishing criteria for recognizing Intangible Assets apart from Goodwill
- Eliminating Negative Goodwill
- Enhanced disclosure requirements
- Basing Purchase Price Allocation on the Fair Values of the assets acquired and the liabilities assumed

SFAS 142 "Goodwill and Other Intangible Assets"

As Business Combinations are the only transactions that lead to Goodwill, SFAS 141 and 142 are totally intertwined, just as were APB 16 and its twin, APB 17 "Goodwill and Intangible Assets". APB 17 determined that goodwill was an asset that should be amortized over its useful life, a period not to exceed forty years.

Now SFAS 142 has abandoned amortization of Goodwill and Intangible Assets with indefinite lives, and replaced it with a mandatory annual Goodwill Impairment Test. Before undertaking this, Intangible Assets, both those that continue to be amortized over their useful lives and those no longer being amortized, have to be tested for Impairment under SFAS 144.

SFAS 144 "Accounting for the Impairment or Disposal of Long Lived Assets"

This supersedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", and replaces certain provisions of APB 30 "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." It retains the fundamental provisions of SFAS 121 related to:

a) The recognition and measurement of the impairment of long-lived assets to be held and used; and
b) The measurement of long-lived assets to be disposed of by sale or otherwise, and those designated to be held and used until disposal; it establishes more restrictive criteria to classify long-lived assets held for sale.

In addition, SFAS 144 replaces the accounting and reporting provisions of APB 30 for the disposal of a segment of a business. However, it retains the basic requirement that discontinued operations should be reported separately and extends such reporting to a component of an entity.

It is confusing, isn't it? But look at it this way: the Standards have resulted in many opportunities for valuation analysts. This paper discusses the key features of the Standards and some of these opportunities; for further information and "how to" instruction, you might be interested in future presentations at NACVA's Career Development Institutes in New Orleans (October 27 to November 1) and in San Diego (December 1 to 6, 2003).

REPORTING UNITS

SFAS 142 introduces a new concept, the Reporting Unit. This is an Operating Segment, or a component of one. Most public companies have reporting systems that satisfactorily show the results of the various Operating Segments established by SFAS 131 "Disclosures about Segments of an Enterprise and Related Information". Therefore, the "segment level" is reasonably familiar to accounting staff, even though the SEC sometimes requests additional segregation; however, the concept of a component is new.

FASB decided that a Reporting Unit is either an Operating Segment, which may be functional or geographic, or a component of one such segment, if it:

- Constitutes a business with separate Financial Statements (even if a Balance Sheet has to be created)
- Is subject to regular reviews of operating results by segment management
- Has individually dissimilar economic characteristics.

Useful guidance to establishing Reporting Units is found in EITF (FASB's Emerging Issues Task Force) - Topic D-101.

The question arises if this means further segmentation by geography, technology, products, customers, or something completely different. Deciding on what activities are to be included in each Reporting Unit is a complex matter, based on how the organization's various entities are organized and managed. It requires management, the auditor and the valuation analyst to work together. A golden middle has to be found to satisfy the Standards and guidance, yet serve the business by avoiding excessive, time-consuming demands for extra data.

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. Under SFAS 142, not only do all assets and liabilities, including Intangible Assets and Goodwill, have to be allocated to a Reporting Unit, but each such entity has to be valued separately.

Determining What Goes to Which Reporting Unit

The first factor in allocating business activities to a Reporting Unit is to look at how they are managed. As an example, consider Anaconda Electronics, which is based on a real client: it consists of two Operating Segments, Calibration and Telecom, each with a Division Executive

Vice-President. The Calibration Division has five offices, of which two serve only the military, two both defense and commercial customers, and one only civilian businesses. The Telecom Division has three units: Cable, Power and Instrumentation, each with a General Manager.

Which are the Reporting Units?

The military and commercial activities of the Calibration Division are totally intertwined in three of the five offices, sharing staff and equipment; it is not practical to separate them, even though they have different economic characteristics. As a result, the Calibration Division is to be considered as a Reporting Unit.

Though all activities of the Telecom Division deal with the same customers, they have different buying cycles; also, they are physically separated, with Power and Cable at one location, and Instrumentation in another city, where it shares a building with a calibration office. The physical linking of Power and Cable makes them effectively a single Reporting Unit, even though separate Financial Statements are prepared based on costs being allocated from time records.

Why is the Identification Important?

Reporting Units are important because all recorded assets, financial, physical and intangible, have to be allocated to one. In addition:

- All Goodwill must be allocated to the Reporting Units that are expected to benefit from anticipated synergies; the other assets or liabilities of the acquired business, that gave rise to such Goodwill, may be assigned differently;
- Other assets and liabilities are assigned to a Reporting Unit, if they will be:
  - Employed in, or relate to its operations
  - Considered in determining its Fair Value

This is a Fundamental Change in Thinking;
Goodwill Now Does Not Relate Solely to the Corporate Entity

INTANGIBLE ASSETS AND GOODWILL

In the three years from 1998 to 2001, approximately 28,800 Business Combinations took place in the United States, resulting in an enormous increase of Intangible Assets. For the S&P 500 Index, they grew by 30%, while for the S&P mid-cap (another 500 companies), the gain was nearly 300%. Their importance led to new definitions and more disclosures.

What are Intangible Assets?

An intangible must be recorded as an Intangible Asset other than Goodwill, if it meets either of the following criteria:

Contractual or Legal

- Assets that arise from contractual or other legal rights

Separable

- Assets that can be separated from the entity and sold or transferred either alone or with other assets
- Examples of the six classes of Intangible Assets are set out in the Appendix.

A Summary of the Criteria

		Contractual or Other Legal Rights	
		Yes	*No*
Separable	*Yes*	Intangible Asset	Intangible Asset
	No	Intangible Asset	Goodwill

Carrying Values

Purchased Intangible Assets are to be recorded at their established Fair Values.

Previously Acquired

While there is no need to restate previous purchase price allocations under SFAS 142, the goodwill shown on the Balance Sheet from previous acquisitions must be reviewed to check if it contains any items that are now considered Intangible Assets; they should be removed from Goodwill, if they:

- Meet the new recognition criteria
- Were assigned a Fair Value at the time of acquisition
- Have separate accounting records, such as an amortization schedule

Any items removed should be appropriately recorded. The useful lives of all previously acquired Intangible Assets, however recorded, must be reviewed, so that all intangibles are properly amortized.

The SEC has indicated that it may require financial service companies to transfer certain Intangible Assets from Goodwill to Intangible Assets, even if they were not formally valued when acquired.

From an impairment vulnerability perspective, companies that reclassified previously acquired items to Intangible Assets from Goodwill, may have to face a charge in Step 2 of the Goodwill Impairment Test. Such reclassified Intangible Assets would be included in the Goodwill's Book Value, but not in its implied Fair Value. FASB understands those unintended consequences, but accepts them, because there is no obvious workable solution. Once again, that rare commodity, common sense, must be applied.

Assembled Workforce

Under APB 17, an Assembled Workforce was regarded as an Intangible Asset. Although it can be transferred with a plant and thus meet the separability criterion, it is no longer an Intangible Asset according to SFAS 141; any remaining amounts for such assets are to be grouped with Goodwill. Although FASB recognized that the intellectual capital of an Assembled Workforce is an important resource to many entities, it made that decision because Replacement Cost was normally used to value it. Their comment in SFAS 141 - B169 was:

> "The Board believes that Replacement Cost is not a representatively faithful measurement of the fair value of the intellectual capital acquired in a business combination".

In Process R&D

Although it meets the criteria to be an Intangible Asset, FASB continues the previous treatment of writing-of In-Process R&D at the acquisition date. This was set out in FASB Interpretation ("FIN") 4 "Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method", which, according to FASB SFAS 141 - B170 applies to "...the amounts assigned to tangible and intangible assets to be used in a particular research and development project that has no alternate future use"; the emphasis is in the original.

Internally Created

The costs of internally creating, developing, or maintaining Intangible Assets will continue to be recognized as expenses when incurred and will not capitalized. Internally generated intangibles are not Intangible Assets, but are implicitly considered in Step 2 of the Goodwill Impairment Test, as they are reflected in the Fair Value of a Reporting Unit.

Useful Lives

The useful life of an asset is the period over which it is expected to contribute directly or indirectly to the future Cash Flows of its owner. It should be based on analyses of all pertinent factors, in particular:

- The expected use of the asset by the entity
- The level of maintenance expenditures required to obtain the expected future Cash Flows; for example, a material level of required maintenance in relation to the Carrying Amount of the asset may suggest a limited useful life.

The useful life of an Intangible Asset to a Reporting Unit is to be considered indefinite, if no legal, regulatory, contractual, competitive, economic, or other factors limit it.

The term **INDEFINITE** does <u>not</u> mean **INFINITE**

Amortization

Intangible Assets are to be amortized over their useful lives to the Reporting Unit, unless that life is determined to be indefinite. Recognized Intangible Assets that are no longer in use, should be allocated a limited life or considered part of Goodwill. Indefinite-lived Intangible Assets are to be tested for Impairment at least annually under SFAS 144.

What is Goodwill?

Goodwill is defined by FASB as:

> "The excess of the cost of an acquired entity over the net of the amounts [Fair Values] assigned to assets acquired and liabilities assumed. The amount recognized as Goodwill includes acquired Intangible Assets that do not meet the criteria for recognition in paragraph 39 [of SFAS 141] as intangible assets apart from goodwill".

According to SFAS 141 - B102, goodwill had six components:

- The excess of the Fair Values over the Book Values of the acquired entity's net assets at the Acquisition Date
- The Fair Values of net assets that were not recorded on the books of the acquired entity
- The Fair Value of the Going Concern Element of the acquired entity's existing businesses
- The Fair Value of the synergies expected from combining the acquired entity's net assets and businesses with those of an operation carried on by the acquirer
- Overvaluation of the consideration paid by the acquirer
- Overpayment or underpayment by the acquirer

The first two of those are now allocated directly to the assets involved; the other four remain as Goodwill. In our view, the last two may be grouped into one.

Valuations under the Standards

For SFAS 141, 142 and 144, together with other FASB pronouncements, we now must use Fair Value rather than our dearly beloved Fair Market Value. For this, FASB gives us the following definition:

> "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".

Thereby the Fair Value of a Reporting Unit is the amount at which the unit as a whole would be bought or sold in a current transaction between willing parties.

Fair Value is not the same as Fair Market Value, as it takes into account:

- Special purchasers
- Expected synergies

It must be obtained using the best information available and the most appropriate methodologies; FASB recognizes them in this order:

1. Quoted market prices, if available
2. Prices for similar assets (comparables)
3. Present value techniques (Discounted Cash Flows)
4. Other methods, such as Capitalization of Earnings, or, in some cases, Replacement Cost.

Determining Fair Value

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

Cost

In general, the Fair Value of an asset, especially an intangible, is not directly related to either its original or replacement cost. A firm's technology, for example, does not reflect its R&D expenditures, but their results. Similarly, advertising costs incurred to acquire new customers is a poor indicator of the Fair Value of the related trade name. FASB raised this in discussing Assembled Workforces, where it believes that Replacement Cost is not to be considered a "representationally faithful measurement of the fair value of the intellectual capital acquired in a business combination".

Two areas where we have found the Cost Approach useful in establishing Fair Value are: the reproduction costs of internally generated computer software and of physical assets, such as property, plant and equipment.

Market

SFAS 141 gives 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. However, 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."

Comparability is critical, but, alas, there are few sales of many of the assets that we are required to value; most are multi-asset transactions that include both tangible and intangible items.

Income

The Income Approach is the most commonly used for intangible assets; two of its methods are discussed in SFAS 142. The first is the Net Income Method, on which FASB comments, as follows, in paragraph 25:

> "In estimating the fair value of a Reporting Unit 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."

In other words, the value multiple should come from comparables.

One of the most difficult tasks is determining the amount of revenue or income that can be generated by any particular asset. This may 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 assets.

The second income based method discussed in SFAS 142 is Discounted Cash Flow, which FASB refers to as the Present Value Technique; paragraph 24 states:

> "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 information is available without undue cost and effort. Otherwise, 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, a valuation analyst determining Fair Value should look at FASB Concepts Statement No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements"; this sets out the essential elements of a Fair Value measurement, provides examples of circumstances in which an entity's expected Cash Flows might differ from those projected by the market, and discusses measuring the Fair Values of assets and liabilities.

THE GOODWILL IMPAIRMENT TEST

FASB believes that Goodwill is a residual: the amount that is left after all financial, physical and Intangible Assets and liabilities of a Reporting Unit are restated to their Fair Values.

SFAS 142 indicates that a Goodwill Impairment Test is required:

- At least once a year on the same date; this does not have to be the year-end; each Reporting Unit may choose its own time
- When one of the following occurs, if it is likely to reduce the Fair Value of the Reporting Unit:
    - A significant adverse change in a legal situation or in the business climate
    - An adverse action or assessment by a regulator
    - Unanticipated competition
    - A loss of key personnel

  - A more-likely-than-not expectation that a Reporting Unit or a significant portion of a Reporting Unit will be sold or otherwise disposed of
  - The testing for recoverability under SFAS 144 of a significant asset group within a Reporting Unit
  - Recognition of a Goodwill Impairment Loss in the Financial Statements of a subsidiary that is a component of a Reporting Unit.

Applying the Goodwill Impairment Test

Applying the Goodwill Impairment Test is a two-step process.

Step 1 - Determining Potential Impairment:

- Compares the Fair Value of a Reporting Unit with its Carrying Amount (accounting Book Value, including recorded Goodwill)
- If the Fair Value is greater than its Carrying Amount, then there is no impairment
- If the Carrying Amount is greater than the Fair Value, Step 2 is to be undertaken to measure the amount of impairment

Any testing for impairment of the Carrying Amounts of long-lived assets under SFAS 144 must be completed before Goodwill may be tested under SFAS 142. This is also a two-step Impairment Test, which is to be applied to all Intangible Assets:

- Step 1: Identifies if an asset (asset group) is impaired; it uses undiscounted Cash Flows to determine if the Carrying Amount of the asset (asset group) is recoverable over its useful life. If the undiscounted Cash Flows are less than the Carrying Amount, there is impairment
- Step 2: If an asset (asset group) is impaired, the Impairment Loss is the difference by which the Carrying Amount of the asset (asset group) exceeds its Fair Value; this is normally determined by discounting the Cash Flow.

Step 2 - Measuring the Impairment Loss

This step compares the implied Fair Value of the Goodwill with the Reporting Unit's Carrying Amount:

- The implied Fair Value of the Goodwill is determined in the same manner as the amount of Goodwill in a Business Combination
- To establish the implied Fair Value of the Goodwill, all other assets and liabilities must be valued
- If the Carrying Amount of a Reporting Unit's Goodwill exceeds the implied Fair Value of that Goodwill, then an Impairment Loss must be recognized for an amount equal to the excess
- Only the value of Goodwill is adjusted through this process; no other assets are affected
- The Impairment Loss cannot exceed the Carrying Amount of the Goodwill

- The reduced Carrying Amount of the Goodwill will be its new accounting basis. Once written down, it remains at that level and cannot be restored to its original amount in the future.

Over time, as practitioners get more experience and US GAAP converges with that of the International Accounting Standards Board, there will undoubtedly be changes in the implementation of the Goodwill Impairment Tests, although the concept is unlikely to be altered.

Management Attitudes

Intangible Assets are usually soft and fuzzy; for a CPA trained to deal with assets hard and well defined, they can be disconcerting. Some managers fear that reporting assets at Fair Values will require divulging competitive information. To an even greater degree, the same attributes apply to internally developed intangibles. Attempting to isolate and value the Intangible Assets of companies may be counterproductive, according to the Brookings Institution, a Washington, D. C. 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 relationships, and other factors." Brookings believes 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, they consider trying to separate the value of the Coca-Cola brand name from the other assets that contribute to and benefit from it is a meaningless exercise. I totally disagree.

Purchase Price Allocations

The Purchase Price Allocations of acquisitions, the determination of their Intangible Assets and the assignment of assets, liabilities and Goodwill to the various Reporting Units is a source of potential problems for auditors; it also opens the door to management shenanigans similar to those that occurred with one-time charges.

In some cases, after a bad quarter or a 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 also the Return-on-Equity jumps substantially, as the numerator (profits) is higher and the denominator (equity) lower. Some observers are apprehensive about managements being tempted to follow that path when dealing with the Goodwill Impairment Test.

Assume a business has two Reporting Units, one of which is doing well, 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 taken as a result of the initial Goodwill Impairment Test may 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 to the poorly performing unit and present the Impairment Loss in the first fiscal year as an accounting change.

The value of the Intangible Assets must be amortized over their useful lives, but Goodwill only requires meeting the Impairment Test; therefore, there is also concern that managements will undervalue the Intangible Assets in Purchase Price Allocations, in order to reduce amortization charges.

Taxation

The new FASB accounting rules for Goodwill and Intangible Assets have no impact on their tax treatments. Before the addition in 1993 of Section 197 to the Internal Revenue Code, 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.

ROLE OF THE VALUATION ANALYST

In the three Statements SFAS 141, 142 and 144, FASB has blessed us with some 325 pages of guidance; amendments, reactions and commentary, which includes our forthcoming book, will follow like the ‘amen’ to the prayer. They have created significant opportunities for valuation analysts to undertake Fair Value assignments and Goodwill Impairment Tests, both of which are likely to generate substantial fees; however, there is a negative side to this - the need for us to thoroughly familiarize ourselves with a whole new set of rules, almost like going back to school.

None of this will be easy. Intangible Assets tend to require definition on a case-by-case basis, and it is essential to avoid any suggestion that the values are in any way a subjective view. While most CPA firms have some valuation capabilities, they are prohibited from undertaking such work for their publicly traded audit clients, and, in my view, are running a risk in doing so for those that are privately owned. It is recommended and much safer to look to experienced and reputable specialists to work with them in setting up the Reporting Units and establishing Fair Values for all the financial, physical and Intangible Assets as well as the liabilities involved. Besides, if they chose specialized valuation analysts, there is little likelihood that other business, such as ongoing accounting and tax work, would be poached.

Another essential item is to select appropriate valuation methodologies; these will vary from asset to asset and from country to country, depending on the availability of industry information and benchmark data.

As all this is fairly new and there are few precedents for establishing Fair Values for the various Intangible Assets, it is important to keep more detailed documentation than for normal engagements. It should be assumed that any public company's decisions, actions and methodologies will be questioned by the regulatory authorities, perhaps even tested in a court of law. While private companies are free from regulatory oversight, they are subject to possible lawsuits by disgruntled shareholders.

To end with some advice from Anne Morrow Lindbergh: "The wave of the future is coming and there is no fighting it". At least make sure that you get there with all the appropriate tools.

Market-Related Intangible Assets

- Trademarks, trade names
- Service marks, collective marks, certification marks
- Trade dress (unique colour, shape or package design)
- Newspaper and magazine mastheads
- Internet domain names
- Non-competition agreements

Trademarks are words, names, symbols, or other devices used to indicate the source of the product and distinguish it from those of others. A service mark identifies the source of a service rather than a product. Collective marks are used to identify goods or services of members of a group. Certification marks verify the geographic origin or other characteristics of a good or service. Trademarks, service, collective and certification marks may be protected legally through registration with government agencies, continuous use in commerce, and, depending on the State, by other means.

The terms "brand" and "brand name" are often used as synonyms for trademarks and trade names. However, the former are general marketing terms typically used to refer to a group of complementary assets, such as the trademark (or service mark) and its related trade name, formula, recipe and technological expertise, which may or may not be patented. An enterprise may recognize, as a single asset apart from Goodwill, a group of complementary Intangible Assets commonly referred to as a brand, if the items making up that group have similar useful lives.

An Internet domain name is a unique alpha-numeric symbol used to identify a particular Internet address. Registration of a domain name associates it for a stated period, usually five years, with a designated computer on the Internet.

Customer Related Intangible Assets

- Customer lists
- Order or production backlogs
- Customer contracts and associated relationships
- Non-contractual customer relationships

Customer lists consist of names and contact information of a product's or service's buyers; it is often in a database that includes other material, such as order history and demographics. While they do not relate to any contractual or other legal rights, they are valuable, and are frequently leased or exchanged. For that reason, FASB considers that an acquired customer list meets a criterion for recognition as an Intangible Asset. However, it does not meet it when terms of confidentiality or other agreements prohibit an enterprise from selling, leasing, or otherwise exchanging customer information.

If an acquired order or production backlog arises from contracts, such as purchase orders, it meets a criterion for recognition as an Intangible Asset, even if the purchase orders are cancellable.

When an enterprise establishes relationships with its customers as a result of regular contact, and the customer has the ability to deal directly with the entity, the customer relationships become contractual rights. Those customer contacts and the associated relationships are Intangible Assets, even when confidentiality or other contractual terms prohibit their sale or transfer separately from the acquired enterprise. If a customer relationship does not arise from a contract, but can be transferred with some other asset, it also meets a criterion to be an Intangible Asset.

Exchange transactions for the same or a similar type of asset provide evidence of separability of a non-contractual customer relationship; they may also give price information helpful in determining Fair Value. For example, relationships with bank depositors may be transferred together with the accompanying deposits and thereby meet a criterion for recognition as an Intangible Asset.

An acquired customer base is an Intangible Asset; however, it generally does not meet a criterion for recognition apart from Goodwill, as it does not arise from contractual or other legal rights, nor can it generally be bought and sold separately from the acquired enterprise other than as a customer list or database.

Artistic-Related Intangible Assets

- Plays, operas, ballets
- Books, magazines, newspapers, literary works
- Musical works, such as compositions, lyrics, jingles
- Pictures, photographs
- Video and audio-visual material, including motion pictures, music videos and television programs & commercials
- •Sports logos and players' promotional arrangements

Artistic-related items meet a criterion for recognition as Intangible Assets when they arise from legal rights, such as copyright, which can be transferred either in whole through its assignment, or in part through licenses.

The Fair Value of a copyright requires consideration be given to all outstanding assignments or licenses. An acquirer may recognize a copyright and any related assignments or licenses as a single Intangible Asset.

Contract-Based Intangible Assets

- Licenses, royalties, standstill agreements
- Advertising, construction management, service or supply contracts
- Leases
- Approvals
- Franchises
- Airport landing gates
- Servicing rights, such as for mortgages
- Employment contracts

Servicing rights are a specialized type of contract-based Intangible Asset. While servicing is inherent in the ownership of any financial asset, it becomes a distinct item only when contractually separated from the underlying assets. This may be through their sale, by securitization with the servicing rights retained, or through the separate purchase and assumption of the servicing.

Where mortgage loans, credit card receivables, or other financial assets are acquired in a business combination with servicing retained, the inherent servicing rights are not separately recognized as an Intangible Asset; their Fair Value is included in that of the related financial assets. However, a contract representing servicing rights is an Intangible Asset.

When the terms of a contract give rise to a liability or commitment, such as when an operating lease or customer contract is unfavourable, that liability or commitment must be recognized immediately.

Technology-Based Intangible Assets

- Patents
- Computer software and programme formats
- Non-patented technology
- Databases
- Trade secrets, such as formulae, processes, recipes

Technology-based Intangible Assets relate to innovations or technological advances. In many cases, their future economic benefits are protected through contractual or other legal rights and as such meet a FASB criterion.

Databases are collections of information, often stored in electronic form, such as on computer disks. An acquired database that includes original works of authorship is entitled to copyright protection and meets a criterion. However, a database often includes information created as a result of an enterprise's normal operations, such as a customer list, or specialized data, like scientific or credit information. Databases that are not protected by copyright can be (and often are) exchanged, licensed, or leased to others, in part or in their entirety. Even when the future economic benefit of a database does not arise from legal rights, it normally meets a criterion.

A trade secret is information, including a formula, pattern, compilation, algorithm, device, method, technique, or process, that derives independent economic value, actual or potential, from not being generally known, and is the subject of efforts that are reasonable in the circumstances to maintain its secrecy. Such protected information is recognized as an Intangible Assets only when a criterion is met, which is likely to be the case, in particular, when laws or regulations legally protect its future economic benefits, as they do in certain States.

Statute-Based Intangible Assets

- Broadcasting licenses
- Cable TV municipal franchises
- Taxi medallions
- Construction permits
- Hospital operating permits
- Medical licenses
- User rights, such as for water, air, minerals, drilling, timber cutting and route authorities

Licences, franchises, approvals and permits are granted under various statutes by all levels of government, Federal, State, county, municipal as well as their duly appointed agencies. These are normally transferable and thereby meet a criterion.

This category is included with contract-based items in Appendix A of SFAS 141.