

## VALUE ADDED™ Winter, 2001/2002

### Accounting for Business Combinations, Goodwill and Other Intangible Assets

The Financial Accounting Standards Board (FASB) recently issued two new Statements of Financial Accounting Standards, No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets. These new standards dramatically change the accounting for all future mergers and acquisitions, as well as past acquisitions accounted for as purchases. Our fall newsletter presented a brief overview of these new business combination rules. This article is a continuation of the discussion.

#### General Overview

\* All business combinations must be accounted for using the purchase method; use of the pooling-of-interests method is prohibited.

\* At the time of an acquisition, goodwill will continue to be recognized as the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed.

\* Intangible assets acquired in a business combination shall be recognized as an asset apart from goodwill if that asset arises from contractual or other legal rights. FASB has provided a list of intangibles that, if acquired in a business combination, would generally meet the criteria for recognition:

- o trademarks, noncompetes, customer lists and relationships, order backlogs
- o creative intangibles such as books, musical compositions, and photographs
- o contract-based intangibles such as licensing agreements, leases, mortgage servicing rights, and timber rights
- o technology-based intangibles such as patented and unpatented technology, domain names, databases, and trade secrets

#### Amortization and Impairment Testing

##### --Goodwill

\* Goodwill should not be amortized, but should be tested for impairment annually at the reporting unit level.

\* A reporting unit is the same level as or one level below an operating segment (per FASB No. 131 Segment Reporting).<sup>1</sup>

\* Nonpublic companies that are not required to report segment information in accordance with FASB No. 131 are required to test goodwill for impairment at the reporting unit level. An entity may have only one reporting unit, in which case goodwill would be tested for impairment at the entity level.

\* Goodwill should be tested for impairment using a two-step approach:

1. Compare the fair value of the reporting unit to its carrying amount, including its goodwill.
2. If fair value is less than carrying amount, compare the implied fair value of goodwill to its carrying amount. Impairment loss is recognized equal to that excess, if any of the carrying amount of goodwill and the implied fair value of the goodwill.

\* Impairment losses should be presented as a separate line in the operating section of the income statement.

\* The fair value measurement supporting the goodwill impairment test could be performed at any time during the fiscal year as long as that measurement date is used consistently from year-to-year.

#### Amortization and Impairment Testing

##### --Other Intangibles

\* Recognized intangible assets will be classified as having either an indefinite life or a finite life.

\* Recognized intangible assets with indefinite lives should be amortized until its life is determined to be finite. Such intangible assets should, however, be tested for impairment at least annually by comparing the

fair value of the intangible asset to its carrying amount.

\* Recognized intangible assets with finite lives should be amortized over their useful lives and reviewed for impairment in accordance with FASB No. 121.

#### Effective Dates

\* Effective for fiscal years beginning after December 15, 2001. Retroactive application is not permitted.

\* Previously recognized goodwill and other intangibles (arising from acquisitions completed before 7/01/01) should be accounted for in accordance with the new procedures.

\* Companies should perform the first step of the impairment test within six months of initially applying the Statement. For the transitional impairment test, fair value should be measured as of the first of the fiscal year. Impairment loss from the transitional test should be recognized as a change in accounting principle.

\* Intangible asset provisions apply to intangible assets recognized separately from goodwill at the date of acquisition.

#### Required Disclosures

\* The primary reason for the acquisition, including a description of the factors that contributed to a purchase price that results in recognition of goodwill.

\* For each impairment loss recognized: a description of the facts and circumstances leading to the impairment, the method of determining the fair value of the reporting unit (whether based on quoted market prices, prices of comparable businesses, or a present value or other valuation technique).

#### Conclusion

Our professionals at VMI can assist you in complying with the new FASB standards. We provide experience and independence in areas such as the following:

- \* Establish implementation plan
- \* Identify reporting units
- \* Determine identifiable intangible assets
- \* Perform valuations of reporting units and individual assets
- \* Allocate purchase prices
- \* Determine useful lives
- \* Perform impairment tests
- \* Determine residual values
- \* Analyze effects of pending or proposed acquisitions, dispositions and reorganizations
- \* Document methodologies, assumptions and calculations

For more information about these Standards or to discuss a goodwill impairment issue in confidence, please call us.

1. FASB No. 131 defines an operating segment as a component of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance.

2. Fair value is defined in FASB Statement of Financial Accounting Concepts No. 7 Using Cash Flow Information and Present Value in Accounting Measurements, as 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.

#### WHAT TO LOOK FOR IN AN IMPAIRMENT TESTING EXPERT

How do you hire an expert to test goodwill for impairment? Here's a top ten list - certainly not all-inclusive, but something to think about when engaging an outside expert for SFAS 141/142 services.

1. BROAD (AND DEEP) EXPERIENCE. Some valuation practitioners believe that being a SFAS 141/142 expert requires a deep understanding of business valuation. Others think the rubber meets the road in

valuing intangibles, and that being a SFAS 141/142 expert requires vast experience in purchase price allocation work. The answer is that they're both right. Substantiating the value of a company's goodwill required advanced skill in business valuation, and really has little to do with purchase price allocation. But phase two of a SFAS 141/142 engagement, after you've determined that the value of a reporting unit may not justify the goodwill balance, is all about purchase price allocation and intangible asset valuation. A SFAS 141/142 expert (or team of experts) should be experienced at both.

2. VALUATION EXPERT VS. INDUSTRY EXPERT. Is it preferable to have a "valuation professional" or an "industry expert"? This question can be addressed from several perspectives. After twenty years of doing this as a company, we have concluded that, in general, it is preferable to have a valuation expert with broad industry experience to determine the fair market value of a business interest. Industry experts often lack the detailed knowledge of appropriate valuation methodologies for determinations of fair value.

3. A COMPREHENSIVE UNDERSTANDING OF THE PRONOUNCEMENT. Valuation for the compliance with this standard is a unique animal and is new to everyone working on it. Nonetheless, some valuation practitioners will clearly have done their homework more than others. Make certain that your expert has thoroughly researched and understood the valuation implications of complying with the pronouncement.

4. INDEPENDENCE OF APPRAISER. The purpose of the pronouncement is to have independent verification of the goodwill balance on a company's asset list. The independence of a SFAS 141/142 expert is like oxygen: it will not matter until it is questioned; and then it will be the only thing that matters. Appraisal reports should specify who is being retained by whom. Further, any previous or existing business relationships between the entity and the appraiser should be disclosed. An appraiser should state whether or not there are any factors that could call his or her independence into question. The reader of an appraisal should therefore be able to form his own opinion about the appraiser's independence.

5. QUALIFICATIONS. Is your expert qualified? How do you know? Other than what is listed elsewhere in this discussion, it may be helpful to examine an expert's credentials. Are they recognized by any primary finance and valuation organizations? Look for the letters ASA, CFA and/or CPA. A good team will include analysts who have proven their skills by earning these credentials.

The ASA stands for Accredited Senior Appraiser and is issued by the American Society of Appraisers. Without a doubt, the ASA is the most rigorous business appraisal designation currently offered. The ASA means that an analyst has five years of full-time business valuation experience, had their own reports endure extensive peer review, passed a lengthy skills test, and has also been tested in professional ethics and standards.

The CFA stands for Chartered Financial Analyst and is issued by the Association for Investment Management and Research. A CFA charter holder has endured three grueling (by any standard) tests which require a level financial knowledge in excess of all but a handful of MBA programs, has been recommended by established members of the society, and has at least three years of substantial experience in finance. Everyone (reading this, at least) knows what a Certified Public Accountant is, but having CPAs on your SFAS 141/142 team is critical because of the level of communication that your expert will have to have with your auditors.

6. USER-FRIENDLY. Can the analysis be explained, reproduced, believed? For various reasons we at Mercer Capital see appraisals performed by dozens of other firms every year. Much like the need for independence, the need for the analysis to be credible is not really thought about much until the conclusion is called into question. Scrutiny can turn an expert into an idiot faster than you might think.

7. UNDERSTANDABILITY. This is another way to consider whether an expert's work product is user friendly. Simply put, an expert's work-product should be understandable by the lay reader as well as the professional appraiser. Our advice here is straight-forward: If you cannot understand it, do not stand for it!

8. LITIGATION SUPPORT. The valuation practitioners cannot serve as an advocate for the client, but it is always helpful to have an experienced business appraiser available for expert opinion testimony. In addition to providing a well-reasoned and documented report, the appraiser must be able to articulate the reasonableness of valuation and investment conclusions to the court and be able to deal with intensive

cross-examination.

9. A VALUE-ADDED MINDSET. An expert's work-product should add value to the process, not just a bill. A quality expert will provide the appropriate level of work product and support to fit the needs of the client rather than providing the client with something akin to War & Peace merely to justify the bill. We have heard it said that some valuation practitioners are viewing pronouncement as the "business appraisers' full-employment act."

The more important focus should be on independently assisting companies with understanding their balance sheets from a market value perspective, instead of an historical cost perspective. This is a sea change for most finance and accounting professionals, and a good SFAS 141/142 expert will recognize the need to assist the users of their opinion with an understanding of its implications.

10. EXPECT THE BEST. In most cases, the fee for appraisal services is nominal compared to the dollars at risk. The marginal cost of getting the best is negligible. Clients and their advisors can help their appraiser do the best job possible by ensuring full disclosure and expecting an independent opinion of value. The best experts have the experience and credentials described above, but recognize the delicate balance between art and science that enables them to interpret the qualitative responses to due-diligence interviews and put them in a stylized format that quantifies the results.

Excerpted from Valuation for Impairment Testing: The Finance and Accounting Professional's Guide to Valuing Reporting Units for Compliance with SFAS 142, Mercer Capital, (Peabody Publishing, December 2001). Reprinted with permission.

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