



M & A

Insider

Quarterly Guide of Trends and Information about Buying and Selling Mid-Size Companies

GOODWILL IS DEAD! LONG LIVE GOODWILL!

By Rob Slee

The Financial Accounting Standards Board (FASB) establishes accounting standards in the United States. Its recent Statement, No. 142, describes the new accounting treatment of goodwill and other intangible assets. As opposed to amortizing goodwill over 40 years, the new rule does not allow for goodwill amortization. Further, for just about every company that has engaged in business combinations in the United States, FASB requires an annual test for goodwill impairment, which basically means that if goodwill carried on the balance sheet is worth more than its current "fair value," the difference must be written off.

This new rule caused 59 U.S. public companies to write-down more than \$200 billion in the first quarter of 2002 alone. According to John Wood, a national expert in this area, this write-down number could rise to \$1 trillion this year. This article will review FASB 142 and discuss its likely impact on the M&A industry.

FASB 142

The definition of goodwill has not changed with the new statement. Goodwill continues 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 must be reported apart from goodwill if such assets are: i) capable of being separated or divided from the entity, and ii) arise from contractual or other legal rights. Intangible assets that meet the "separable" and/or "contractual-legal" criteria for recognition include:

- Marketing-related, such as trademarks and trade names
- Customer-related, such as customer lists and backlogs
- Creative-type, such as books, musical compositions and photographs
- Contract-based, such as licensing agreements, leases and operating rights

- Technology-based, such as patents, domain names, databases, and trade secrets

Although goodwill/intangibles with *indefinite* lives are not to be amortized, they must be tested for impairment annually at the *reporting unit* level. Reporting unit is a new concept and basically means the operating segment that carries the goodwill/intangibles on its balance sheet. The impairment test uses a two-step approach:

The fair value of the reporting unit's equity, including goodwill, is compared to its book value. If the fair value exceeds its book value, then no impairment is indicated and no further testing is required;

If fair value is less than the book value, the implied fair value of goodwill is compared to its book value. Impairment loss is recognized equal to the excess of the book value of goodwill and the implied fair value of the goodwill.

There are a couple of noteworthy items here. Public *and* nonpublic companies are required to complete the impairment test each year. Second, the fair value measurement can be performed at any time during the year, as long as that measurement date is used consistently from year-to-year.

Third, intangible assets with *indefinite* lives should not be amortized until their lives are determined to be finite. Intangible assets with finite lives should be amortized over their useful lives.

The Valuation

Fair value is defined as "the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than a forced or liquidation sale." The measurement of fair value constitutes the amount at which a reporting unit could be sold in a current transaction between willing parties. An independent valuation professional should perform this appraisal, and will probably rely on the following:

- Comparison to quoted market prices
- Prices for similar assets
- Present value techniques, with a reliance on probability-weighted analysis
- Other valuation techniques, such as multiples of earnings

Although FASB did not definitively describe fair value methodology, it is clear that market-oriented valuations will be preferred wherever possible.

The Effect

The most immediate effect of Statement 142 (and its cousin, Statement 141, which prohibits pooling-of-interests) is the forced recognition of sins-of-the-past deal making. Of course, this new rule in combination with the dot.com meltdown is a potent elixir for write-downs. The longer-term effect should be felt in several ways:

1. Buyers of smaller, private deals will have one more reason to acquire assets of the target. This is because goodwill is not recognized in asset sales. The purchase price is allocated between the tangible assets and the remainder is allocated to intangibles. The buyer will want to allocate as much as possible to intangibles with finite lives so amortization is maximized, thereby creating a noncash expense in the future, and thus reducing income taxes.
2. Public acquirers, on the other hand, will want to allocate the remainder to goodwill or get the intangibles grouped with

indefinite lives so amortization does not apply. Reported earnings, not cash flow, still dominate the financial mindset of most public companies.

3. Pricing of deals with a high degree of intangibles should *decrease* due to the risk of impairment write-downs in the future. Market volatility plays a part here, because there is no reversal of an impairment loss should the fair value subsequently recover, i.e., goodwill can not be "written-up" after it has been "written-down."

Potential acquirers should work with valuation professionals and investment bankers who can help ascertain the impairment risk prior to completing an acquisition. In a sense, this team approach will determine whether goodwill lives or dies.

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