



**BDO Seidman, LLP**  
Accountants and Consultants

# Financial Reporting

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## FASB Proposes to Kill Poolings

Over the years, no accounting subject has consumed as much consulting time as business combinations, particularly with the merger mania of the last decade. The continuing need for interpretations of the complex rules in this area, coupled with a move to harmonize international standards, led the Financial Accounting Standards Board (FASB) to issue a two part Exposure Draft (ED), *Business Combinations and Intangible Assets*, designed to (1) prohibit pooling-of-interests accounting and (2) change the rules governing goodwill and other intangible assets. The demise of pooling and the consequent amortization of goodwill over no more than 20 years would radically reduce net income in many cases. However, to soften the criticism these changes are likely to generate, the ED would permit a separate earnings per share figure to be shown for income before goodwill charges (net of related taxes). The final standard would be effective for business combinations initiated after its issuance. The basic provisions of the ED are described below. The full ED can be downloaded from the FASB Web site: [www.rutgers.edu/accounting/raw/fasb](http://www.rutgers.edu/accounting/raw/fasb). (Select *Publications* from the menu, then select *Exposure Drafts*.)

### Part I: Business Combinations

Part I generally applies to all acquisitions of a controlling interest in another company, regardless of the form of consideration. Accordingly, it covers the exchange of one business for another. However, it excludes transfers of assets between companies under common control, which should be accounted for at historical cost. All business combinations would be accounted for as purchases, as described in APB Opinion No. 16, regardless of the type of consideration paid.

Sometimes in a stock for stock deal, the smaller company may actually wind up in control. In these cases, it may not be clear which company is the acquiror and which is the target. These are facts and circumstances determinations that should consider relative voting rights, board composition and other factors.

The cost of an acquired company would be allocated to its assets and liabilities under the rules of APB 16. In that regard, the ED would not change the existing requirement of FASB Interpretation No. 4 to charge to expense the amounts assigned to assets used in a particular research and development project and that have no alternative future use. However, the accounting for in-process R&D has been extremely contentious of late and has been the subject of severe criticism and related guidance from the SEC staff (See *Financial Reporting - February 1999 - "SEC Year in Review"*).

To enable goodwill to be tested for recoverability under the provisions of SFAS 121, it would be allocated to individual asset groupings, usually on a pro rata basis using the relative fair values of the acquired long-lived assets and identifiable intangible assets.

When the fair value of identifiable net assets exceeds the cost of the acquisition, there would be a multi-step approach to accounting for this *negative goodwill*. The excess would first be applied to reduce intangibles without an observable market, and

then to depreciable non-financial assets and other acquired intangibles. Any remaining excess would be recorded in the income statement as an extraordinary item.

The proposed footnote disclosures include a condensed balance sheet of the acquired company. The existing APB 16 requirement to disclose the pro forma income statement effect of the acquisition would be eliminated.

## Part II: Intangible Assets

### *Amortization of Goodwill*

The maximum period for amortizing goodwill would be cut in half to 20 years. Write-off of goodwill in the year of acquisition would be prohibited unless circumstances changed.

### *Amortization of Other Intangibles*

Reliably measurable intangibles other than goodwill would be amortized over their economic useful lives, which is presumed to be 20 years or less, unless they meet certain tests permitting non-amortization. The amount of the intangible to be amortized would be reduced by its residual value.

The presumed 20-year ceiling may be overcome if the intangible generates clearly identifiable cash flows and either the asset is exchangeable or its future benefits are controlled through contractual or legal rights extending beyond 20 years (e.g., a trademark that

is expected to generate cash flows for 35 years and is renewable at little cost). Moreover, if the intangible has an indefinite economic life supported by clearly identifiable cash flows and has an observable market, it would not be amortized (e.g., a successful broadcast license that may be renewed indefinitely at little cost).

### *Impairment Assessments*

Goodwill and other amortizable intangibles would be reviewed for impairment based on the guidance in SFAS 121 and other indicators proposed in the ED (e.g., a significant decrease in the stock price of the acquiring company that is inconsistent with the overall market). The ED provides additional indicators of possible goodwill impairment. A loss would be recognized if the carrying amount of the asset is not recoverable and it exceeds its fair value. If certain factors exist (e.g., a significant premium was paid over the market capitalization of the target), goodwill would have to be tested for impairment no later than two years after acquisition.

Intangibles not being amortized would be reviewed for impairment annually based on a comparison with observable market prices.

### *Financial Statement Presentation*

Goodwill and other intangibles would be shown as separate line items on the balance sheet. Goodwill amortization and write-offs would be shown

on a net-of-tax basis as a separate line in the income statement. In addition, companies could show per share amounts for this item and the immediately preceding subtotal. Appendix I contains an illustrative income statement.

## Effective Date and Transition

The ED would apply to business combinations initiated after the date the final standard is issued and to intangibles acquired in transactions initiated after that date. There is a two-tiered proposal for intangibles already on the books or pending at that date:

- The unamortized balance of goodwill that was being accounted for under Accounting Research Bulletin No. 43 (i.e., pre-1970 goodwill) would be written off immediately as a cumulative effect of an accounting change.
- Other intangibles accounted for under ARB No. 43 or APB Opinion No. 17 and goodwill accounted for under Opinion 17, which are recognized in transactions initiated before the final standard is issued, would continue to be accounted for under those pronouncements.

Comments on the ED are due by December 7, 1999 and public hearings are planned in the first quarter of 2000.

## Appendix 1

**ABC Company**  
**Income Statement**  
**Year Ended December 31, 20XX**  
**(\$000s)**

Sales	\$10,000
Cost of sales	<u>(6,000)</u>
Gross profit	4,000
Selling, general, and administrative expenses	2,800
Other income	<u>25</u>
Income before goodwill charges, taxes, and discontinued operations	1,225
Income tax expense	<u>(490)</u>
Income before goodwill charges and discontinued operations	735
Goodwill charges (net of \$93 tax benefit)	<u>(139)</u>
Income before discontinued operations	596
Loss from discontinued operations (net of \$40 tax benefit)	<u>(60)</u>
Net income	<u><u>\$ 536</u></u>

**Basic and diluted earnings per share**

*(1 million shares on a weighted-average basis)*

Income before goodwill charges and discontinued operations	\$ 0.74
Goodwill charges	<u>(0.14)</u>
Income before discontinued operations	0.60
Discontinued operations	<u>(0.06)</u>
Net income	<u><u>\$ 0.54</u></u>

**Material discussed is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual facts and circumstances.**

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