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Accounting for Business Combinations, Goodwill, and Other Intangible Assets

Introduction and Background

In June 2001, after a long and grueling process that took nearly five years, the Financial Accounting Standards Board (FASB or the Board) finalized FASB Statements of Financial Accounting Standards No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets*. Statement 141 addresses business combinations and Statement 142 deals with intangible assets acquired individually, with a group of other assets, or in a business combination. Collectively, these new Statements not only eliminate the pooling-of-interests method of accounting (pooling method), but also significantly change the accounting for goodwill by ending its amortization and introducing a new complex valuation model to test it for impairment. All future business combinations will be affected, as well as goodwill and recognized intangible assets previously acquired.

During its deliberations, the FASB issued a Special Report, an Invitation to Comment, and two Exposure Drafts, held numerous public meetings, heard from 43 constituents in 4 days of public hearings, read well over 550 comment letters, and conducted field visits at 14 companies. The Board also worked with standard-setting bodies of other countries with the goal of obtaining international convergence on this topic.

Why Did The Board Do It?

The Board added the project on accounting for business combinations to its agenda for several reasons. The proliferation of business combinations in the early 1990s heightened awareness that companies could account for similar economic transactions using different methods,

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resulting in significantly different financial statement outcomes. Financial statement users advised the Board that those differences were making comparisons among companies more difficult. In addition, there was a perception that the adverse earnings-per-share effect of the purchase method of accounting (purchase method) affected market valuations and competition in markets for mergers and acquisitions. Many companies believed that they were at a disadvantage in competing for target companies if they could not qualify to use the pooling method, while a competitor could do so. These circumstances drove many to try to expand the use of the pooling method, thus pushing the guidance in APB Opinion No. 16, *Business Combinations*, to the breaking point. As a result, the staffs of the FASB and SEC, public accounting firms, and company management expended significant resources analyzing transactions for compliance with the arcane criteria of Opinion 16.

Not an Easy Road

The project proved to be highly controversial as the Board participated in several heated Congressional hearings. In October 2000, two Congressmen even introduced a bill in the House of Representatives in an attempt to stall the project. Opponents of the move to pull the plug on the pooling method requested that the Board keep that method for public policy reasons. However, the Board responded by stating that its decision to eliminate the pooling method was consistent with its public policy goal of issuing accounting standards that result in “neutral and representationally faithful financial information.” The Board believes that “in the context

of business combinations, neutrality means that the accounting standards should neither encourage nor discourage business combinations but rather, provide information about those combinations that is fair and evenhanded.”

In the end, the Board concluded that the new Statements would result in financial statements that better represent the underlying economics of a business combination, are more comparable, and provide more complete information.

The following analysis of the new Statements supplements our previous letter, *The New Age of Goodwill*.

Statement 141 – Business Combinations

Under Statement 141, a company must account for all new business combinations using the purchase method; use of the pooling method is prohibited for transactions *initiated* after June 30, 2001. The Statement continues the existing practice of requiring a company to use the purchase method to account for the acquisition of some or all of the noncontrolling interests in a subsidiary.

The scope of Statement 141 is essentially identical to that of Opinion 16, which has been superseded. Under Statement 141, a business combination occurs when a company acquires net assets that constitute a business or acquires a controlling equity interest in a company. Statement 141 applies regardless of (1) the form of consideration, (2) whether the former owners of one of the combining companies as a group retain or receive a majority of the voting rights of the combined company, or (3) whether the parties

involved are incorporated or unincorporated.

Transactions covered by Statement 141 include those where (1) one or more companies are merged or become subsidiaries, (2) one company transfers net assets or its owners transfer their equity interests to another, (3) there is an exchange of a business for a business, or (4) all companies transfer net assets or the owners of those companies transfer their equity interests to a newly formed company (some of which are referred to as roll-up or put-together transactions). Although some may argue that not all of those types of business combinations are acquisitions, the Board plans to address those issues in another project, including whether a company should account for a business combination using the fresh start method (i.e., both the acquiring and acquired companies would adjust their assets and liabilities to fair value) rather than the purchase method for a transaction that is not an acquisition.

The following are *not* considered business combinations and Statement 141 does not change the accounting for them:

- Joint venture and other new entity formations
- Recapitalization transactions
- Acquisition of some or all of the noncontrolling interests in a subsidiary
- Transfer of net assets or exchanges of equity interests between entities under common control.

Statement 141 does *not* apply to a combination between two or more not-for-profit organizations (NFPO) or to a NFPO’s acquisition of a for-profit company. In addition, it does *not* address transactions in

which a company obtains control through means other than an acquisition of net assets or equity interests (e.g., a previously owned unconsolidated majority-owned company is consolidated as a result of control being obtained by the lapse or elimination of participating veto rights that were held by minority stockholders).

The Statement supersedes Opinion 16; all of the AICPA Interpretations of Opinion 16; FASB Statements No. 10, *Extension of "Grandfather" Provisions for Business Combinations*; No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*; and No. 79, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises*; and amends a number of other pronouncements. Although a great deal of that former guidance is gone, it is not forgotten, as Statement 141 carries forward most of the guidance relating to the purchase method. Specifically, Statement 141 carries forward guidance regarding (1) determining the cost of an acquired company, (2) allocating the costs of an acquired company to the assets and liabilities assumed, (3) preacquisition contingencies, and (4) determining the acquisition date. Guidance carried forward into Statement 141 is clearly identified by a reference to the original source. The Board plans to address some or all of those aspects of the accounting for a business combination in another project.

Statement 141 does not change the consensus reached in EITF Issue No. 97-2, "Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements."

Application of the Purchase Method

The core of the purchase method is essentially the same under Statement 141 as it was under Opinion 16. Accordingly, the following discussion will focus primarily on the new or additional guidance introduced by Statement 141.

Identifying the Acquiring Company

The use of the purchase method requires the acquiring company to be identified. Ordinarily, identifying the acquiring company will be obvious, such as where the acquiring company distributes the cash or other assets or incurs the liabilities. However, transactions that involve the exchange of equity interests (including reverse acquisitions) may require careful review of all the pertinent facts and circumstances. In that regard, the parties should give *equal* weight to the following factors to determine the acquiring company:

- The relative voting rights in the combined company after the combination, which includes considering which group of shareholders receives or retains the larger portion of the voting rights, including the existence of any unusual or special voting arrangements, options, warrants, or convertible securities
- The existence of a large minority voting interest in the combined company when no other owner or organized group of owners has a significant voting interest
- The composition of the board of directors of the combined company
- The composition of senior management of the combined company
- The terms of the exchange of equity securities, if publicly traded (e.g., whether a premium is paid).

In addition, for business combinations involving two or more companies, the parties to the transaction should also consider which combining company initiated the transaction and whether the assets, revenues, and earnings of one of the combining companies significantly exceeds those of the others. If the parties form a new company to issue the equity interests, the acquiring company will be one of the existing combining companies based on applying the above guidance and the evidence available.

Goodwill and Other Intangible Assets

Statement 141 continues the previous requirement for a company to recognize goodwill for the excess of the cost of an acquired company over the fair value of the identifiable assets acquired and liabilities assumed. It also indicates that intangible assets are those (excluding financial assets) which lack physical substance. Although the provisions of Opinion 16 required a company to recognize identifiable intangible assets separately from goodwill, in practice they may often have been included in goodwill.

Keeping past practice in mind and because of its decision to prohibit goodwill amortization, the Board determined that explicit guidance was needed to determine when to recognize an intangible asset separately from goodwill. As a result, Statement 141 requires the acquiring company to recognize an acquired intangible asset separately from goodwill if it meets *either* of the following criteria:

- Control over the future economic benefits of the asset results from contractual or other legal rights (the contractual-legal criterion)
- The intangible asset is capable of being separated or divided

and sold, transferred, licensed, rented, or exchanged either separately or as part of a group of assets (the separability criterion).

A company first must determine whether an intangible asset meets the contractual-legal criterion, even if an asset's rights are not transferable or separable from the acquired company or from other rights and obligations. For example, the value of a favorable operating lease agreement is an intangible asset that meets the contractual-legal criterion, even if the company could not transfer the lease through a sale or sublease.

If the acquired intangible asset does not satisfy the contractual-legal criterion, the company must determine whether the asset meets the separability criterion, even if the acquiring company does not intend to sell, transfer, license, or exchange it. Exchange transactions provide evidence of meeting the separability criterion, even if they are infrequent for that type of asset or a similar type asset and even if the acquiring company is not involved in them. For example, if the acquiring company is capable of selling or renting an acquired intangible asset (e.g., a customer list), but does not plan to do so, but other companies sell or rent similar type items, the asset meets the separability criterion.

Although an intangible asset may not meet the separability criterion by itself, it still may meet that criterion if it is separable in combination with a related contract, asset, or liability. For example, assume that the company acquired assets that include a registered trademark and unpatented technical expertise to manufacture the trademarked product. Because of certain legal requirements, if the acquiring company sells the trademark, it also

must sell the unpatented technical expertise. As a result, the unpatented technical expertise meets the separability criterion.

An exception to the above criteria is that a company must include an assembled workforce as part of goodwill. Although some believe that an assembled workforce could meet the criteria for separate recognition, the Board provided the exception primarily because it believed that companies could not adequately measure its fair value.

The following acquired assets are examples of those that meet the *contractual-legal* criterion:

- Registered or legally protected trademark or other mark
- Registered Internet domain name
- Order or production backlog arising from contracts, even if cancelable
- Customer contracts and the related customer relationship, even if terms prohibit transfers
- Servicing asset
- Legally protected artistic-related materials, computer software, mask works, program formats, databases, and trade secrets.

In addition, the following acquired items are examples of those that meet the *separability* criterion:

- Customer lists, except if terms prohibit transfer
- Databases, including title plants that are not legally protected by copyright.

Paragraph A14 of Statement 141 provides a more detailed listing of intangible assets that meet the criteria for recognition as an asset apart from goodwill. This listing is not all-inclusive, so the acquiring company will need to evaluate all of the criteria for separate recognition of intangible assets based on the

facts and circumstances of each individual business combination.

After initial recognition of goodwill and acquired intangible assets, the acquiring company should account for those assets using the guidance in Statement 142.

Because earnings can be significantly affected by whether an item is classified as non-amortizable goodwill or as an amortizable intangible asset, companies can expect the SEC staff to review closely such classifications.

Negative Goodwill

In some business combinations, the fair value of the acquired net assets exceeds the cost of the acquisition (i.e., negative goodwill). The basic principle in accounting for negative goodwill is similar to what Opinion 16 required, with some exceptions. First, after reassessing the facts and circumstances of the original purchase price allocation, a company should allocate the excess as a pro rata reduction of the amounts assigned to all of the acquired assets (including research and development assets acquired and expensed), *except for*:

- Financial assets, other than investments accounted for by the equity method
- Assets to be disposed of by sale or otherwise and assets of a discontinued operating segment
- Deferred tax assets
- Prepaid assets relating to pension or other postretirement benefit plans
- Any other current assets.

A company should recognize any remaining excess as an extraordinary gain, unless the transaction involves contingent consideration.

If the purchase agreement includes contingent consideration that could increase the purchase

price, the company should defer the excess as if it were a liability in an amount equal to the *lesser* of the maximum amount of the contingent consideration or the excess. When the contingency is satisfied, the acquiring company should account for the additional consideration as part of the cost of the acquired company and then determine whether negative goodwill still exists. If it does, the company should allocate that amount as a pro rata reduction of the assets and liabilities as described above. The company should recognize any remaining excess as an extraordinary gain in the period in which the contingent consideration is resolved. It is possible for a company to report an extraordinary gain in two different reporting periods for the same business combination where the maximum amount of contingent consideration is less than the negative goodwill (see Example 1).

Example 1
**Extraordinary Gain in
More Than One Period**

Assume that the maximum amount of the contingent consideration is \$1,000, negative goodwill is \$3,000, the acquisition date is in the company's second quarter, and the contingency period ends in nine months, at which time the contingency is resolved for \$300. In this case, the acquiring company would report a \$2,000 extraordinary gain (\$3,000 - \$1,000) in the second quarter and another \$700 extraordinary gain (\$1,000 - \$300) in nine months.

The above approach also applies to equity method negative goodwill.

Contemporaneous Documentation

Statement 142 requires a company to assign the assets acquired and liabilities assumed in a business combination, including goodwill, to a reporting unit (see discussion of Statement 142) as of the date of the acquisition. In that regard, the acquiring company should document at the acquisition date the basis for and the method for determining the purchase price, including other related factors (e.g., underlying reasons for the acquisition and management's expectations related to dilution and synergies).

Financial Statement Disclosures

To enhance a financial statement user's ability to assess the effects of a business combination on postacquisition earnings and cash flows, Statement 141 significantly expands the previous disclosure requirements of Opinion 16 (see the Table on pages 6 and 7).

Effective Dates and Transition

Except for combinations between two or more mutual enterprises (e.g., mutual insurance companies, credit unions, and farm and rural electric cooperatives), Statement 141 is effective for all business combinations *initiated* after June 30, 2001 and for purchase method business combinations *completed* on or after July 1, 2001. Accordingly, the pooling method is prohibited for business combinations *initiated* after June 30, 2001. However, Opinion 16 would continue to apply to a pooling method transaction initiated on or before June 30, 2001. For combinations between mutual enterprises, Statement 141 is not effective until

the Board issues interpretative guidance related to the application of the purchase method to those transactions.

Statement 141 carries forward the Opinion 16 definition of *initiated* in the context of a business combination. A business combination is initiated on the earlier of when (1) the major terms are set and the exchange offer is announced publicly or formally communicated to the shareholders of any one of the combining companies, (2) the shareholders of either combining company are notified in writing of an exchange offer, or (3) the shareholders of a closely held company grant an option to exchange shares at a future date to another company. An exchange offer refers to the major terms of a plan, including the ratio of exchange (or formula to determine that ratio). The company does not need to know the actual exchange ratio of shares if the ratio of exchange is absolutely determinable by an objective means in the future. A formula would usually provide such a determination.

Conversely, intent to negotiate or make an offer does not constitute initiation of a business combination, nor would granting a right of first offer or first refusal. Changes to previously announced terms and conditions of the exchange offer result in a new initiation date. In addition, if the parties formally terminate negotiations and then subsequently resume negotiations, the resumption creates a new initiation date even if the terms and conditions did not change from the previously terminated plan.

Upon adoption of Statement 142 (see below), for a purchase business combination with an acquisition date before July 1, 2001, a company should reclassify *to*

Statement 141 Disclosure Requirements

Annual disclosures:

1. In the period a material business combination is completed:
 - a. Name and brief description of acquired entity and percentage of voting equity acquired
 - b. Primary reasons for acquisition, including description of factors that contributed to a purchase price that results in recognition of goodwill
 - c. Period that results of operations of acquired company are included in the income statement
 - d. Cost of acquisition and, if applicable, number of shares of equity interests (such as common shares, preferred shares, or partnership interests) issued or issuable, the value of those interests, and basis for determining value
 - e. Condensed balance sheet of acquired company at acquisition date, disclosing the amount assigned to each major asset and liability caption
 - f. Contingent payments, options, or commitments and related accounting treatment that will be followed should any such contingency occur
 - g. Amount of purchased research and development assets acquired and written off in the period and where included in income statement
 - h. Reason for any purchase price allocation not yet finalized; nature and amount of any material adjustments to initial allocation of purchase price
2. If significant amounts are assigned to goodwill or to other intangible assets, the following information must be disclosed in the period in which a company completes a material business combination:
 - a. For *amortizable intangible assets*:
 - 1) Total amount assigned and amount assigned to any major intangible asset class
 - 2) Amount of any significant residual value, in total and by major intangible asset class
 - 3) Weighted-average amortization period, in total and by major intangible asset class
 - b. For *non-amortizable intangible assets*, total amount assigned and amount assigned to any major intangible asset class
 - c. For *goodwill*:
 - 1) Total goodwill and amount expected to be tax deductible
 - 2) Goodwill by reportable segment (if segment information is required by Statement 131), unless not practicable
3. If individually immaterial business combinations are completed during year that are material in the aggregate:
 - a. Number of companies acquired and a brief description of them
 - b. Aggregate cost, number of equity interests (such as common shares, preferred shares, or partnership interests) issued or issuable, and value assigned
 - c. Aggregate amount of any contingent payments, options, or commitments and related accounting treatment that will be followed should any such contingency occur
 - d. The information described in item 2 above, if aggregate amount assigned to goodwill or other intangible assets acquired is significant in relation to total cost of acquired companies
4. For a public company, pro forma disclosures in the period a material business combination or a series of individually immaterial business combinations are completed that are material in the aggregate:
 - a. Results of operations for current period as though the acquisition(s) had been completed at beginning of the period, unless acquisition at or near beginning of period
 - b. Results of operations for only most recent comparable prior period presented as though acquisitions completed at beginning of period
 - c. Pro forma information must include revenue, income before extraordinary items and cumulative effect of accounting changes, net income, earnings per share, and nature and amount of any material, nonrecurring items
5. In period there is an extraordinary gain for unallocated negative goodwill, disclose nature of transaction, principal items entering into determination of gain, and related tax effect.
6. Disclose, if practicable, information in items 1 and 2 above if a material business combination is completed after balance sheet date but before financial statements are issued.

Continued on next page

Interim disclosure requirements for publicly traded companies:

If a material business combination is completed in the current year up to latest interim balance sheet date:

1. Information in items 1.a. – d. above
2. Pro forma results of operations for current interim period and current year to date and for corresponding periods in preceding year as though acquisition had been completed as of beginning of period being reported on. Pro forma information must display rev-

enue, income before extraordinary items and cumulative effect of accounting changes (including those on an interim basis), net income, earnings per share, and nature and amount of material, nonrecurring items

Appendix C of Statement 141 provides illustrative disclosures for a material business combination in the year of acquisition and several individually immaterial transactions that are material in the aggregate.

goodwill the carrying amount of acquired intangible assets that do not meet the criteria for separate recognition. If the intangible asset reclassified to goodwill is an asset for which amortization is not deductible for income tax purposes because it does not have a tax basis, a company should consider the asset as nondeductible goodwill, which is exempt from the deferred tax requirements. As a result, the company would eliminate any deferred tax liabilities associated with the reclassified asset by reducing the carrying amount of the goodwill. If the amortization of the reclassified intangible asset is tax-deductible, it should be deemed to be tax-deductible goodwill and should not affect an already recognized deferred tax asset or liability balance.

The company should also reclassify *out of* goodwill reported on the balance sheet the carrying amount of any *recognized* intangible assets that meet the criteria for separate recognition if the company maintained a separate general ledger account or other accounting records (including separate analyses of the transaction) for those assets (see Example 2). For practical considerations, the Board concluded that, only if a company has identified other intangibles in its internal accounting records or

there is other supporting evidence, is it required to reclassify amounts from goodwill to intangible assets, because reliable information might not otherwise exist to properly reclassify amounts, perhaps years after the fact. Except for the above reclassifications, the transition provisions prohibit a company from reallocating the original purchase price.

Upon the earlier of adopting Statement 142 or the first day of the fiscal year beginning after December 15, 2001, a company must write off, as a cumulative effect of a change in accounting principle, net of taxes, any unamortized unallocated negative goodwill or equity method unallocated negative goodwill from transactions completed before July 1, 2001.

Example 2

Reclassification of Goodwill and Other Intangible Assets

Assume the following: The GCS Generator Company reported \$8,000 of goodwill and intangible assets as a separate line item in its balance sheet. The internal accounting records indicated that goodwill and other intangible assets consist of the following, net of accumulated amortization:

Customer list	\$2,000
Employee workforce	500
Trademark	2,000
Internet domain name	1,000
Goodwill	<u>2,500</u>
	<u>\$8,000</u>

Upon adoption of Statement 142, GCS should reclassify \$5,000 (the customer list, trademark, and Internet domain name) from goodwill to other intangible assets because those assets meet the test for separate recognition. The new carrying amount of goodwill will be \$3,000 (\$8,000 - \$5,000), representing the employee workforce and goodwill.

However, if GCS did not separately identify those assets in its internal accounting records or other supporting evidence does not exist, GCS should not reclassify those amounts from goodwill.

Statement 142 – Goodwill and Other Intangible Assets

Statement 142 addresses the initial accounting for intangible assets acquired individually or with a group of other assets that are not part of a business, as well as the subsequent accounting for (1) goodwill recognized under Statement 141, (2) other intangible assets, regardless of how acquired, (3) amounts recognized as goodwill in applying the equity method of accounting, and (4) excess reorganization value recognized in accordance with AICPA Statement of Position 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*.

While Statement 142 supersedes APB Opinion No. 17, *Intangible Assets*, it carries forward the provisions relating to internally developed intangibles. As a result, a company should continue to expense when incurred costs of internally developing, maintaining, or restoring intangible assets (including goodwill) that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing company and related to the company as a whole.

Accounting for Goodwill

Under this Statement, a company may no longer amortize goodwill, but now will have to test it for impairment at the *reporting unit* level at least annually, absent some triggering event that would accelerate an impairment assessment. Goodwill is considered impaired when its carrying amount exceeds its so-called *implied fair value*. Statement 142 acknowledges that it is not possible to measure directly the fair value of goodwill, noting

that goodwill is measured as the residual amount at acquisition. A similar residual method to value goodwill is used under Statement 141. A two-step impairment test is used to identify potential goodwill impairment and to measure the amount of goodwill impairment loss, if any.

Reporting Unit

Determining the reporting unit is a critical aspect in accounting for goodwill, including its related impairment test. As mentioned earlier, a company must assign the acquired assets and liabilities assumed, including goodwill, to a reporting unit as of the date of acquisition. A reporting unit is an operating segment (as defined in FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*) or one level below it (referred to as a component). A company is required to test goodwill for impairment at the reporting unit level even if it is not required to report segment information under Statement 131 (i.e., the company has only one reportable segment or it is a privately-held company). A component of an operating segment is considered a separate reporting unit if the component meets *all* of the following criteria:

- It is a business for which discrete financial information is available
- Segment management regularly reviews its operating results
- It has economic characteristics different from those of the other components of the operating segment.

To determine whether a component of an operating segment has similar economic characteristics, a company must consider the guidance in paragraph 17 of Statement

131. As such, a company should aggregate two or more components of an operating segment if the segments have similar economic characteristics, and if the segments are similar in *each* of the following areas:

- The nature of the products and services
- The nature of the production processes
- The type or class of customer for their products and services
- The methods used to distribute their products or provide their services
- If applicable, the nature of the regulatory environment (e.g., banking, insurance, or public utilities).

An operating segment is deemed a reporting unit if all its components are similar, none of its components is a separate reporting unit, or it comprises only a single component. The Board believes that a company must aggregate components that have similar economic characteristics into one reporting unit, even if management separately reviews the operating results of a number of components. The Board's rationale was that in those instances allocating the goodwill among the components would be arbitrary and unnecessary for purposes of testing goodwill.

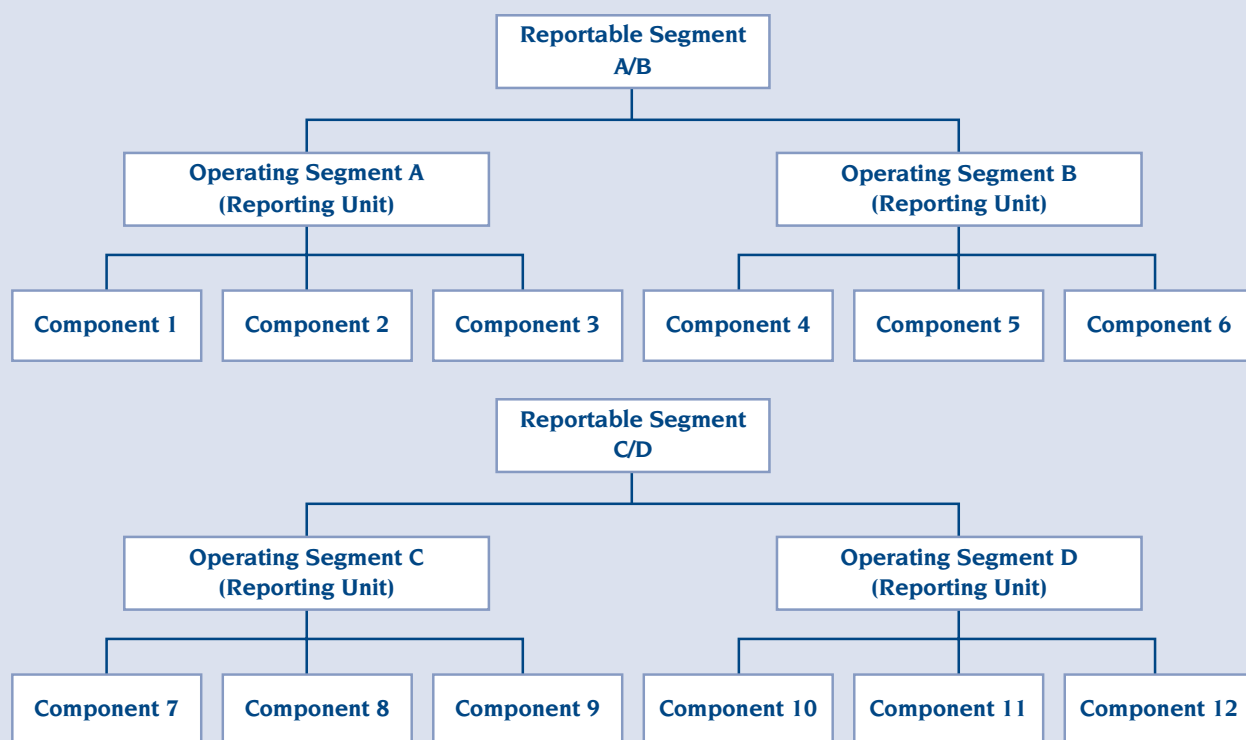
The number of reporting units could vary by company depending on the level at which performance of the operating segment is reviewed, how many businesses it includes, and the similarity of those businesses (see Example 3). As a result, it is possible for a reporting unit to be the same as an operating segment, which could be the same as a reportable segment, which could be the same as the company as a whole.

Example 3

Reporting Unit Same as the Operating Segment

Assume the following facts: The GCS Generator Company has four operating segments (A, B, C, and D) based on product lines. There is a manager for each segment who reports directly to the chief operating decision maker (CODM). The CODM reviews the discrete and detailed financial information for each of the four operating segments. Based on the criteria of paragraph 17 of Statement 131, the Company has aggregated Segments A and B into one reportable segment and Segments C and D into another. To identify the reporting units under Statement 142, management of GCS must start with each of the four operating segments and determine whether it is required to identify any reporting units one level below the operating segment level. GCS's components consist

of various products within each of the four operating segments. The Company has discrete financial information for each of the products within each segment and management of each segment reviews the products' operating results within that segment. Therefore, each product is considered a component of the operating segment. In addition, each of the products within the applicable operating segment has similar economic characteristics (e.g., similar long-term average gross margins). Since the components within each operating segment have similar economic characteristics, GCS cannot use a lower level than the four Statement 131 operating segments to determine the Statement 142 reporting units (i.e., there are four reporting units).



The fact that GCS combined certain of its operating segments to form its reportable segments under Statement 131 is irrelevant for purposes of determining its reporting units in Example 3 because a company should always start at the operating segment level in making this determination. However, if the facts in Example 3

were changed such that GCS considered the products in operating segment A to have different economics characteristics, and thus considered each product line to be a reporting unit, that conclusion might be difficult to support, since the operating segments A and B were combined into a reportable segment based on the similarity of

their economic characteristics. In that case, the SEC staff could raise questions as to the composition of the reportable segments under Statement 131. As is evident from this analysis, some companies may need to re-examine how they have determined their segments under Statement 131.

In many cases, it is expected that the Statement 142 reporting units will be the same as the Statement 131 operating segments. However, Example 4 illustrates what happens when the reporting unit is considered to be a level below an operating segment.

Assigning Assets and Liabilities to the Reporting Units

For purposes of the goodwill impairment test, a company must assign the acquired assets and liabilities (including corporate assets and liabilities, such as environmental liabilities or a pension obligation) to one or more reporting units (either existing or created

by the acquisition) at the acquisition date if *both* of the following criteria are met:

- The asset will be employed in or the liability relates to the operations of a reporting unit
- The asset or liability will be considered in determining the fair value of the reporting unit.

Other corporate items that a company will need to consider in this assignment process are:

- Centralized cash and investment accounts
- Corporate level debt
- Current and deferred income taxes.

There are two objectives of this assignment process:

- To ensure that the assets and liabilities the company assigns to a reporting unit are the same net assets that the company considers in determining the fair value of that reporting unit – an “apples-to-apples” comparison
- To ensure that a company assigns to a reporting unit all of the assets and liabilities required for the reporting unit to operate as a business.

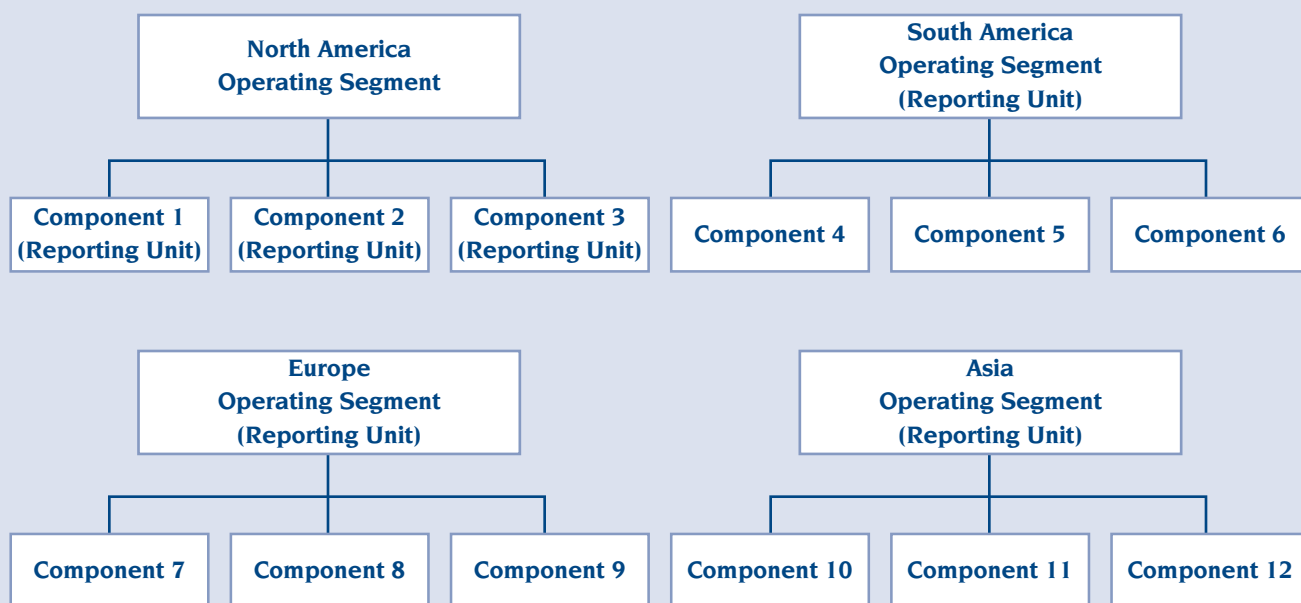
To illustrate, if GCS does not allocate corporate debt to a reporting unit because it does not meet the above criteria, the method used to determine the fair value of that reporting unit should exclude corporate debt. That would result in a

Example 4

Reporting Unit One Level Below an Operating Segment

Assume that AMS Publishing, Inc. has four operating segments based on geographic location (such as North America, South America, Europe and Asia), rather than on product line, and there are three geographic areas within the North American segment, each with different economic characteristics. The CODM does not review financial information by product line. The components in the North American segment are separate businesses for

which discrete financial information is available, they have *different* economic characteristics, and segment management reviews the information and reports directly to the CODM. The components within the other three geographic locations have *similar* economic characteristics. In this case, AMS would have six reporting units, three in North America and one for each of the other geographic areas.



meaningful comparison of the reporting unit's carrying amount to its fair value.

Although it is possible for the company's allocation method to be very general, the methodology should be reasonable, supportable, and applied in a consistent manner.

In addition, a company must assign all acquired goodwill to reporting units at the acquisition date. A company could allocate goodwill among a number of reporting units, including a reporting unit that the company expects to benefit from the synergies of the combination (e.g., incremental cost savings, cash flows or revenues), even though the company may not have assigned other acquired assets or liabilities to that reporting unit. Paragraph 35 of Statement 142 indicates that a company, in concept, should assign acquired goodwill to a reporting unit *in a manner similar to* how a company would recognize goodwill in a business combination. However, strict application of that guidance may be costly in some cases. Therefore, the Statement provides for some flexibility by indicating that a company's methodology for assigning goodwill to reporting units should be reasonable, supportable, and applied consistently. We expect that this area will generate significant implementation guidance.

If a company reorganizes its reporting structure in a way that alters the composition of one or more of its reporting units, it must reassign the assets and liabilities using the above guidance as if it acquired those assets and liabilities as of the date of reorganization. However, a company should reassign to the reporting units goodwill affected by the reorganization using a relative fair value approach simi-

lar to that used when a company disposes of a portion of a reporting unit (as discussed on page 13).

The Goodwill Impairment Test

A company should test goodwill for impairment using a two-step filtering approach. The bedrock of this approach is the determination of fair values.

Step 1

First, to identify a potential impairment, a company should compare the fair value (as discussed on page 12) of a reporting unit to its carrying amount, including goodwill. If the fair value of the reporting unit is *greater* than its carrying amount, goodwill is not considered impaired and the second step is not required. However, if the fair value of the reporting unit is *less* than its carrying amount, the second step should be performed to measure the amount of any impairment loss.

If goodwill and other assets (e.g., long-lived assets, accounts receivable, long-term investments, etc.) are to be tested for impairment at the same time, those other assets should be tested for impairment first and any resulting impairment loss should be recorded to determine the carrying amount of the reporting unit.

The impact of testing the other assets and recording the impairment loss first is that a company may not need to complete the second step of the impairment test because the carrying amount of the reporting unit might now be less than its fair value (see Example 5).

Step 2

The second step requires a company to compare the *implied* fair value of goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, a

Example 5

Revising the Carrying Amount

Assume the fair value of Reporting Unit A of GCS is \$5,000 and its current carrying amount is \$5,250. Also, assume that GCS tested various assets within that reporting unit for impairment resulting in write-downs of \$450 and a new adjusted basis of the reporting unit of \$4,800. Since the adjusted carrying amount of the reporting unit is now below its fair value, GCS will not have to perform the second step of the goodwill impairment test. However, if the amount of the impairment loss were only \$100, GCS would have to perform the second step of the goodwill impairment test because the fair value of the reporting unit would be less than its carrying amount (\$5,150).

company should recognize an impairment loss for that excess as a separate line item in operating income or include it in discontinued operations, if applicable. Previously recognized impairment losses may not be reversed.

A company should calculate the implied fair value of goodwill in the same manner as goodwill arising in a business combination. In that regard, it should allocate the fair value of the reporting unit to all of the assets and liabilities of that unit (including any *unrecognized* intangible assets – e.g., favorable leases and internally developed customer lists) as if the company acquired the reporting unit in a business combination and the fair value of the reporting unit is the purchase price. The excess of the “purchase price” over the amounts assigned to assets and liabilities is the implied fair value of goodwill. In allocating the “purchase price,” a company should use the guidance carried over from Opinion 16 to Statement

141. A company should perform that allocation procedure only for purposes of testing goodwill for impairment; it may not recognize the “step-up” in net assets or any unrecognized intangible assets (see Example 6).

If a company does not complete the second step of the impairment test before issuing its financial statements for the reporting period, and a goodwill impairment loss is both probable and reasonably estimable, the company should recognize the best estimate of the loss in accordance with FASB Statement No. 5, *Accounting for Contingencies*. In that situation, the company should disclose in the notes to the financial statements that the measurement of the impairment loss is an estimate. Upon completion of step 2, a company should recognize any adjustment to the estimated loss in the subsequent reporting period.

The effect of reflecting unrecognized intangible assets in the fair value determination of the reporting unit is essentially like capitalizing internally generated intangible assets, including internally generated goodwill, which is otherwise prohibited by the accounting stan-

dards. Thus, the increasing value of an existing reporting unit that is growing and profitable could offset an impairment loss of a recent acquisition that is included in such a unit. However, if that reporting unit were performing poorly, recognition of an impairment loss might be accelerated. Statement 142 allows such offsetting within a reporting unit, but does not permit offsetting between reporting units.

Fair Value Measurements

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. Thus, the fair value of a reporting unit is the amount at which the unit as a whole could be bought or sold in such a transaction. A company should use quoted market prices, if available, in situations where there is only a single reporting unit or tracking stock to determine the basis for the measurement. 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 represen-

tative of the fair value of the reporting unit as a whole because of issues such as control premium. As a result, a company is not required to use the quoted market price of an individual share of stock as the sole measurement basis to determine the fair value of such a reporting unit.

When quoted market prices are not available at the reporting unit level, the company’s estimate of fair value should be based on the best available information, including pricing for similar assets and liabilities and the results of other valuation techniques, if those techniques are consistent with the objective of measuring fair value. A present value technique that includes reasonable and supportable assumptions of future cash flows is often the best available way to estimate the fair value of a group of assets (such as a reporting unit). FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, discusses the essential elements of a present value measurement, provides examples of circumstances in which a company’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.

It may be appropriate for a company to use multiples of earnings or revenues in determining the fair value of a reporting unit when the fair value of a company that has comparable operations and economic characteristics is observable and the relevant multiples of the comparable company are known.

When to Test for Goodwill Impairment

A company should test goodwill for impairment on an annual basis or earlier if there is an event indicating

Example 6

Determining a Goodwill Impairment Loss

Building on the fact pattern in Example 5, the fair value of the reporting unit is \$5,000 (including \$1,000 fair value of internally developed intangibles) and the adjusted carrying amount is \$5,150, including goodwill with a carrying amount of \$750. The second step of the impairment test is as follows:

Fair value of:		
Reporting Unit A		\$5,000
Tangible net assets	\$2,000	
Recognized intangible assets	1,500	
Unrecognized intangible assets (favorable leases and customer list)	<u>1,000</u>	<u>4,500</u>
Implied fair value of goodwill		500
Carrying amount of goodwill		<u>750</u>
Goodwill impairment loss		<u>\$ (250)</u>

that it is more likely than not that the fair value of the reporting unit is less than its carrying amount. Examples of such indicators include:

- A significant adverse change in legal factors 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 of a significant asset group within a reporting unit under FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*

• A recognized goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit. A company also should test goodwill for impairment after a portion of goodwill has been allocated to a business to be disposed of.

A company does not have to perform the annual impairment test at its year-end. Instead, it may elect to perform the test at any time during its fiscal year as long as it uses the same measurement date consistently from year to year. Different measurement dates may be used for different reporting units. We believe that the optimal date to perform the annual impairment test is the first day of a company's fourth quarter. Performing the test at that time has several advantages.

- The company will have the entire quarter, including up to the due date for filing or submitting annual financial statements, to complete the impairment test

(thus, avoiding additional disclosure requirements if the test is not completed by the time financial statements are issued)

- The appropriate carrying amounts will be available as of the last day of the third quarter (thus, possibly avoiding the need to perform impairment tests of other assets at the same time as testing goodwill for impairment)
- There will be no need to assess whether impairment indicators may exist later if the company performed the test earlier in the year.

As a practical shortcut, a company could carry forward the reporting unit's detailed fair value determination from one year to the next if *all* of the following criteria have been met:

- The assets and liabilities of the reporting unit have not changed significantly since the last fair value determination
- The last fair value amount exceeded the carrying amount of the reporting unit by a substantial margin
- Based on current events or circumstances, it would be remote that a current fair value determination would be less than the current carrying amount.

Although the Statement affords this short cut method, it may be more prudent to update the valuations at least on an annual basis. Once a valuation model is in place, a company should be able to update the information with little effort. The annual update also will (1) allow for the timely identification of events and circumstances that may require the company to complete an impairment test, (2) provide enough time to complete any impairment test, and (3) avoid

being second-guessed by others as to whether the company met the short-cut conditions.

Goodwill Impairment Testing by a Subsidiary

Statement 142 applies to all goodwill recognized by a subsidiary in its separate financial statements. A subsidiary should test for goodwill impairment at the subsidiary level using its own reporting units. The parent company should *not* recognize any impairment loss recognized at the subsidiary level in the consolidated financial statements unless the reporting unit in which the subsidiary resides in consolidation is also impaired. A company *must* test goodwill for impairment at the consolidated level if its subsidiary recognized an impairment loss and the event that gave rise to that loss would more likely than not reduce the fair value of the consolidated reporting unit below its carrying amount.

Test for Goodwill Impairment When Minority Interest Exists

When a company has a minority interest, its test for goodwill should be consistent with the approach used to measure the minority interest at the acquisition date. For example, if a company initially recorded goodwill based on the excess of the purchase price over its majority percentage of the fair value of the net identifiable assets acquired, it should calculate the fair value of the reporting unit based on that controlling interest. Likewise, it should consider only its percentage ownership interest in determining the implied fair value of goodwill.

Disposal of All or a Portion of a Reporting Unit

If a company disposes of a reporting unit in its entirety, goodwill of that reporting unit should be included in

the carrying amount of the net assets to be disposed of to determine the gain or loss on disposal.

When some, but not all, of a reporting unit is disposed of, a company should allocate goodwill to the net assets disposed of if those net assets constitute a business. The amount of allocated goodwill should be based on the relative fair value of the business disposed of and the fair value of the remainder of the reporting unit. The goodwill remaining in the portion of the reporting unit to be retained should be tested for impairment.

However, if a business is disposed of that was never integrated into the reporting unit after its acquisition, and thus the benefits of the acquired goodwill were never realized by the reporting unit as a whole, the current carrying amount of that acquired goodwill should be included in the carrying amount of the business to be disposed of.

Equity Method Investments

A company should no longer amortize the portion of the difference between the cost of an investment and the amount of underlying equity in the net assets of an equity method investee that was recognized as goodwill (i.e., equity method goodwill) in accordance with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. However, equity method goodwill should continue to be tested for impairment in accordance with paragraph 19(h) of Opinion 18, rather than Statement 142.

Accounting for Other Intangible Assets

Initial Recognition and Measurement

A company should recognize and measure an intangible asset

acquired in a transaction other than a business combination at its fair value. When a company acquires intangible assets as part of a group of assets, it should allocate the total cost to the individual assets acquired based on their relative fair values. This allocation does not result in goodwill, which arises only in a business combination. As a result, the criteria in Statement 141 to recognize intangible assets separately from goodwill do not apply to assets acquired in a transaction other than a business combination.

Determining the Useful Life

The subsequent accounting for a recognized intangible asset depends on whether it has an indefinite useful life to the company. Consistent with current practice, a company *should* amortize an intangible asset with a *finite* useful life. On the other hand, it should *not* amortize an intangible asset that has an *indefinite* useful life. The useful life is the period over which the company expects the asset to contribute directly or indirectly to its future cash flows. However, cash flows and useful lives of an intangible asset that a company bases on legal rights are constrained by the duration of those rights. In that situation, the useful life cannot extend beyond the length of the asset's legal rights and may be shorter. If an intangible asset has a finite life, but the company cannot determine the precise length of that life, it should amortize the intangible asset over the best estimate of the useful life.

The useful life of an intangible asset is indefinite if it extends beyond the foreseeable horizon. However, indefinite does not mean infinite.

In determining the estimated useful life of an intangible asset, a

company should analyze all pertinent factors, including:

- The asset's expected use by the company
- The expected useful lives of related assets
- Legal, regulatory, or contractual provisions that may limit the useful life or whether the company can renew or extend the asset's legal or contractual life without substantial cost, provided there is evidence this can be done without material modifications of the existing terms and conditions
- The effects of obsolescence, demand, competition, and other economic factors
- The level of funds needed to maintain the asset to achieve the expected future cash flows (e.g., a material level of required maintenance may suggest a limited useful life).

An intangible asset has an indefinite useful life if, after performing this analysis, a company finds that there are no legal, regulatory, contractual, competitive, economic, or other factors limiting its useful life. Examples of indefinite useful life intangible assets include, but are not limited to, certain trademarks, renewable broadcast licenses, and taxicab medallions.

Amortizable Intangible Assets

A company should amortize a finite-life intangible asset over its estimated useful life, up to its residual value, in relationship to the pattern in which the company uses up the intangible asset's economic benefits. If the pattern of consumption cannot be reliably determined, the straight-line method should be used. A company may not write down an intangible asset in the period it is acquired unless it became impaired during that period.

The residual value of an intangible asset is assumed to be zero unless the useful life to the acquiring company is shorter than the asset's economic life and (1) a commitment exists from a third party to purchase the asset at the end of its useful life, or (2) the residual value can be determined by reference to an observable market for that asset and that market is expected to exist at the end of the asset's useful life. Residual value is determined net of any disposal costs.

A company should reevaluate the useful lives of amortizable assets at least each annual reporting period, absent some triggering event that would accelerate the assessment, with any changes in the estimated useful lives accounted for prospectively over the revised remaining useful life. If an amortizable intangible asset is subsequently determined to have an indefinite useful life (e.g., due to a change in legal requirements), the company should test for impairment under Statement 142 (see discussion below) and cease amortization on a prospective basis.

An amortizable intangible asset is subject to the impairment guidance in Statement 121. Under that Statement, if an impairment indicator is present, the company must evaluate the recoverability of the asset based on a two-part test. An impairment loss would be recognized if (1) the carrying amount of the intangible asset is not recoverable and (2) the carrying amount exceeds its fair value. The amount of any impairment loss reduces the intangible asset to its new accounting basis. Statement 121 prohibits the reversal of a previously recognized impairment loss for assets held for use.

Nonamortizable Intangible Assets

A company must reevaluate at each annual reporting period (absent some triggering event that would accelerate the assessment) whether an indefinite life intangible asset continues to have an indefinite useful life. If a company subsequently determines that an intangible asset has a finite useful life (e.g., because of unanticipated competition entering the market), it should write down the asset if its carrying amount exceeds its fair value. It would then begin to amortize the intangible asset on a prospective basis based on its remaining useful life.

An indefinite life intangible asset should be tested for impairment annually, or more frequently if an event or circumstance occurs between annual tests which indicates that the asset might be impaired. The impairment test consists of comparing the fair value of the intangible asset to its carrying amount. An impairment loss is recognized if the carrying amount of the intangible asset exceeds its fair value. The amount of any impairment loss reduces the intangible asset to its new accounting basis. Previously recognized impairment losses may not be reversed.

Deferred Income Taxes

Statement 142 does not change the requirements in FASB Statement No. 109, *Accounting for Income Taxes*, related to goodwill and intangible assets. Accordingly, a deferred tax liability should be recognized for the excess of the book basis over the tax basis of goodwill arising in taxable purchases. Respondents to the 2001 Exposure Draft argued that such deferred taxes should not be recorded since the liability would not be settled until the indefinite future. However, the Board felt that

this argument was made for other situations when Statement 109 was debated, so no change in its provisions is warranted.

Financial Statement Presentation

Goodwill should be aggregated and shown as a separate line item on the balance sheet. The aggregate amount of goodwill impairment losses should be presented as a separate line item in the income statement before the subtotal *income from continuing operations* (or similar caption), unless it is associated with a discontinued operation. In that case, the company would report the goodwill impairment within the results of discontinued operations, on a net-of-tax basis.

All other intangible assets must be aggregated and shown on the balance sheet unless a company chooses to present individual intangible assets or classes of intangible assets as separate line items. Amortization expense and impairment losses for intangible assets should be shown within continuing operations in the income statement. See Table 2 on page 16 for the disclosures required by Statement 142.

Effective Dates and Transition

Statement 142 is required to be applied in fiscal years beginning after December 15, 2001 to all goodwill and other intangible assets recognized at that date, regardless of when those assets were initially recognized. A company may elect to adopt the provisions earlier only if it has a fiscal year beginning after March 15, 2001 and it has not issued its financial statements for the first interim reporting period. For those companies, the attraction of early adoption resulting from cessation of goodwill amortization needs to be

Statement 142 Disclosure Requirements

1. For intangible assets acquired, either individually or with a group of assets, disclose in the period of acquisition:
 - a. For amortizable intangible assets:
 - 1) Total amount assigned and amount assigned to any major intangible asset class
 - 2) Amount of any significant residual value, in total and by major intangible asset class
 - 3) Weighted-average amortization period, in total and by major intangible asset class
 - b. For non-amortizable intangible assets – total amount assigned and amount assigned to any major intangible asset class
 - c. Amount of research and development assets acquired and written off in period and where included in income statement
2. For each period for which a balance sheet is presented:
 - a. For amortizable intangible assets:
 - 1) Gross carrying amount and accumulated amortization, in total and by major intangible asset class
 - 2) Aggregate amortization expense for period
 - 3) Estimated total amortization expense for each of next five years
 - b. For non-amortizable intangible assets – total carrying amount and the carrying amount for each major intangible asset class
 - c. Changes in carrying amount of goodwill during the period including:
 - 1) Total amount of goodwill acquired
 - 2) Total amount of impairment losses recognized
 - 3) Amount of goodwill included in gain or loss on disposal of a reporting unit
 - 4) If segment information required by Statement 131:
 - a) Provide above information about goodwill in total and for each reportable segment
 - b) Disclose significant changes in allocation of goodwill by reportable segment
 - c) If any portion of goodwill is not yet allocated to a reporting unit, disclose that unallocated amount and the reasons for non-allocation
3. For each intangible asset impairment loss, disclose the following information in the period of loss:
 - a. Description of impaired intangible asset and underlying facts and circumstances
 - b. Amount of loss and method for determining fair value
 - c. Where loss is included in income statement
 - d. Segment in which impaired intangible asset is included under Statement 131
4. For each goodwill impairment loss recognized, disclose the following in the period of loss:
 - a. Description of facts and circumstances leading to impairment
 - b. Amount of loss and method of determining fair value of reporting unit (whether based on quoted market prices, prices of comparable businesses, a present value or other valuation technique, or a combination thereof)
 - c. If loss is an estimate not yet finalized, that fact and reasons and, in subsequent periods, adjustments made to initial estimate

Transitional disclosures

1. When first step of goodwill impairment test is completed, disclose in interim financial information the reportable segments in which an impairment loss might be recognized and period potential loss will be measured.
2. In period of initial application and thereafter, until goodwill and other intangible assets are accounted for under Statement 142, disclose (i) what income before extraordinary items and net income would have been, excluding amortization expense for goodwill, intangible assets that will no longer be amortized, any deferred credit related to negative goodwill and equity method goodwill, and adjusted for changes in amortization periods for intangible assets that will continue to be amortized, (ii) a reconciliation of reported net income to adjusted net income, and (iii) adjusted earnings-per-share.

Appendix C of Statement 142 provides illustrative disclosures for periods subsequent to a business combination and for transition.

weighed against the acceleration of the need to cope with the complex impairment test. In all cases, a company must apply the provisions of the Statement as of the beginning of its fiscal year. Retroactive application is not permitted.

At the date of initial application, a company should establish its reporting units, assign the recognized net assets and the existing goodwill to those units, and, if necessary, reclassify amounts among goodwill and other intangibles. In addition, an SEC-reporting company will need to disclose in filings through the date of initial adoption the potential effects of adopting the Statement unless the impact on the financial statements is not expected to be material. (See separate section below on such disclosures.)

A company should not amortize goodwill and indefinite life intangible assets acquired in a purchase business combination or other transaction completed after June 30, 2001. However, until a company first applies all of Statement 142, it should continue to use existing impairment guidance for all goodwill and other intangibles and continue to amortize such assets arising from acquisitions completed before July 1, 2001. As a result, for the period between July 1, 2001 and the date the new Statement is applied, a company could find itself in the anomalous situation of amortizing previously acquired goodwill and indefinite life intangible assets at the same time it is not amortizing such newly acquired assets, and with all such assets being subject to the old impairment tests.

Transitional Impairment Tests

Goodwill

A company should test goodwill of each reporting unit for impairment

as of the beginning of the fiscal year in which the Statement is first applied. The first step of this transitional goodwill impairment test (i.e., comparing the carrying amount of the net assets, including goodwill, with the fair value of the reporting unit) should be completed within six months of initial adoption of the Statement. A calendar year company should complete this step by June 30, 2002; however, a company with a June 30, 2001 fiscal year-end, that does not elect early adoption, would have until December 31, 2002 to complete it. If a company determines that events or changes in circumstances indicate that goodwill of a reporting unit *might* be impaired before the six-month deadline, it should accelerate its impairment test. If the first step indicates that the carrying amount exceeds the fair value of the reporting unit, the company should complete the second step of the test as soon as possible, but no later than the end of the fiscal year of adoption.

Any impairment loss resulting from the transitional impairment test should be reported as a cumulative effect of a change in accounting principle. However, if a loss results from an accelerated impairment test, the company should generally present the loss as a separate line item in operating income. If the company completes the test after the end of the first quarter, no amendment of prior SEC filings is required for any resulting impairment loss. However, a restatement of each of the prior quarters' results should be included in the filing for the quarter in which the company adopts the new accounting principle and in the annual Form 10-K quarterly financial information. If, after completing the first step, the

company determines that there is a potential impairment loss, it must disclose that information in any interim financial reporting period.

In addition to the required transitional goodwill impairment test, a company must also complete the required annual goodwill impairment test in the year of adoption. However, the company may use the transitional test as the annual test, if it designates the beginning of the fiscal year as the date for its annual impairment test.

Other Intangible Assets

In the first interim reporting period after initial adoption, a company should reassess the useful lives of intangible assets other than goodwill that were acquired before July 1, 2001 and, if necessary, adjust the remaining amortization periods. At the same time, a company is also required to test indefinite life intangible assets for impairment as of the beginning of the fiscal year, with any resulting impairment loss reported as a cumulative effect of a change in accounting principle.

See Table 3 on page 20 for a summary of the complex effective date and transition requirements.

Required Disclosures for SEC Reporting Companies

An SEC registrant should disclose the potential effects of adopting Statements 141 and 142 in its filings with the SEC for periods subsequent to June 30, 2001, unless the impact on the financial statements is not expected to be material. Under Staff Accounting Bulletin Topic 11M, *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period* (SAB 74), a registrant should provide the following disclosures:

- A brief description of Statements 141 and 142
- The date the company must adopt the Statements or, if the company is eligible for early adoption, the date it plans to adopt
- The expected impact of the Statements on the reported financial position and results of operations. If the company has quantified the impact and that amount is material, the estimated amount should be disclosed. However, if the amount is immaterial or the impact is not known or reasonably estimable, a statement to that effect should be made.

SAB 74 Sample Disclosure

In June 2001, the Financial Accounting Standards Board finalized FASB Statements No. 141, *Business Combinations* (SFAS 141), and No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). SFAS 141 requires the use of the purchase method of accounting and prohibits the use of the pooling-of-interests method of accounting for business combinations initiated after June 30, 2001. SFAS 141 also requires that the Company recognize acquired intangible assets apart from goodwill if they meet certain criteria. SFAS 141 applies to all business combinations initiated after June 30, 2001 and for purchase business combinations completed on or after July 1, 2001. It also requires, upon adoption of SFAS 142, that the Company reclassify the carrying amounts of intangible assets and goodwill based on the criteria in SFAS 141.

SFAS 142 requires, among other things, that companies no longer amortize goodwill, but instead test goodwill for impairment at least annually. In addition, SFAS 142 requires that the Company identify reporting units for the purposes of assessing potential future impairments of goodwill, reassess the useful lives of other existing recognized intangible assets, and cease amortization of intangible assets with an indefinite useful life. An intangible asset with an indefinite useful life should be tested for impairment in accordance with the guidance in SFAS 142. SFAS 142 is required to be applied in fiscal years beginning after December 15, 2001 to all goodwill and other intangible assets recognized at that date, regardless of when those assets were initially recognized. It also requires the Company to complete a

transitional goodwill impairment test by six months from the date of adoption. The Company is also required to reassess the useful lives of other intangible assets within the first interim quarter after adoption of SFAS 142.

The Company's previous business combinations were accounted for using both the pooling-of-interests and purchase methods. The pooling-of-interests method does not result in the recognition of acquired goodwill or other intangible assets. As a result, the adoption of SFASs 141 and 142 will not affect the results of past transactions accounted for under the pooling-of-interests method. However, all future business combinations will be accounted for under the purchase method, which may result in the recognition of goodwill and other intangible assets, some of which may subsequently be charged to operations, either by amortization or impairment charges. For purchase business combinations completed prior to June 30, 2001, the net carrying amount of goodwill was \$18,165 and other intangible assets was \$8,916 as of September 30, 2001. Amortization expense during the nine-month period ended September 30, 2001 was \$1,624. The Company is assessing but has not yet determined how the adoption of SFAS 141 and SFAS 142 will affect its future financial position and results of operations.

Information in the last paragraph of this example should be based on the individual facts and circumstances of a particular company at the time of filing its financial statements with the SEC.

Getting Ready

Companies will need to plan carefully to implement the new Statements. In summary, a company will need to perform the following steps:

- Determine whether it will be necessary to reclassify to goodwill the carrying amount of any intangible assets acquired before July 1, 2001 that do not meet the criteria for separate recognition
- Determine whether it will be necessary to reclassify out of goodwill the carrying amount of any recognized intangible assets that meet the criteria for separate recognition if a separate general ledger account or other accounting records are maintained
- Determine whether it will be necessary to write off, as a cumulative effect of a change in accounting principle, net of taxes, any unamortized unallocated negative goodwill or equity method unallocated negative goodwill from transactions completed before July 1, 2001
- Determine the reporting unit(s)
- Assign assets and liabilities to the reporting unit(s)
- Assign all acquired goodwill to the applicable reporting unit(s)
- Complete the following transition steps by their required dates:
 - Test goodwill of each reporting unit for impairment as of the beginning of the year in which Statement 142 is first applied
 - Reassess the useful lives of the amortizable intangible assets
 - Complete the transitional impairment test for non-amortizable intangible assets by comparing the fair value to the carrying amount of the asset
- Prepare any necessary interim disclosures, including those required by SAB 74
- Determine the date(s) for the annual impairment test(s)
- Consider engaging a valuation specialist to perform or provide advice on the following procedures during the transition period and annually thereafter:
 - Determining the value of indefinite life intangible assets and the residual value of amortizable intangible assets
 - Valuing the assets and liabilities in allocating purchase prices on new acquisitions
 - Valuing the reporting unit(s) and the assets and liabilities within the reporting unit(s)
 - Developing the company's own valuation model to allocate the purchase price, to value the assets and liabilities within reporting unit(s), or to determine the value of the reporting unit(s).

BDO is prepared to assist you, where appropriate, in implementing these steps.

Looking Ahead

The new Statements for business combinations and goodwill and other intangible assets represent a landmark in financial reporting. The complexities of the pooling method have been replaced by a more judgmental set of impairment stan-

dards. We anticipate that the judgment needed to determine reporting units and fair value will spawn a whole new body of interpretive literature. So, the new Statements, as originally issued, may only be the tip of the iceberg.

If you would like to obtain more information on the new

Statements and the services BDO can provide, please contact your BDO engagement partner or, for non-clients, please contact our Director of Accounting, Frank Scheuerell:

Phone: (212) 885-8194

Fax: (212) 697-5076

e-mail: fscheuerell@bdo.com.

Summary of Effective Dates

Table 3

Company Year-End	Amortization of Goodwill and Other Indefinite Life Intangibles	Adoption of New Rules on Impairment of Goodwill
Calendar year	• Business combinations completed before 7/1/01 – cease amortization 1/1/02	1/1/02
	• Business combinations completed after 6/30/01 – no amortization	1/1/02
Fiscal year beginning after 3/15/01 but before 12/15/01	• Business combinations completed before 7/1/01 – If first quarter 10-Q not yet filed – cease amortization as of the beginning of fiscal year starting in 2001 or 2002	Apply as of same date amortization ceases
	– If first quarter 10-Q has been filed – cease amortization as of the beginning of fiscal year starting in 2002	Beginning of fiscal year starting in 2002
	• Business combinations completed after 6/30/01 – If first quarter 10-Q not yet filed – no amortization	Beginning of fiscal year starting 2001 or 2002
	– If first quarter 10-Q has been filed – no amortization	Beginning of fiscal year starting in 2002
Other fiscal year-end (e.g., 1/31/01, 2/28/01)	• Business combinations completed before 7/1/01 – cease amortization beginning of fiscal year starting in 2002	Beginning of fiscal year starting in 2002
	• Business combinations completed after 6/30/01 – no amortization	Beginning of fiscal year starting in 2002

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