

Accounting for Business Combinations: The FASB Acts

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On June 27, 2001, the Financial Accounting Standards Board (FASB) took long awaited action upon its 1999 and 2001 Business Combinations and Intangible Assets exposure drafts. Statement 141, *Business Combinations*, and Statement 142, *Goodwill and Other Intangible Assets*, are being finalized and are due for release in late July. With certain limited exceptions, Statement 141 will generally apply to all business combinations initiated after June 30, 2001, and Statement 142 will apply to fiscal years beginning after December 15, 2001.

By its action, the FASB has recognized the increasing role of intangible assets in modern business transactions. Intangible assets are current and noncurrent assets that lack physical substance, financial instruments excepted. This monograph contains an overview of the FASB's pronouncements. It is not a substitute for professional accounting analysis and advice which should be sought in connection with any transaction and financial reporting activity.

Business Combinations

A *Business Combination* occurs when an enterprise acquires assets or the assets and associated liabilities of a business and consequently obtains control. An exchange of businesses is specifically deemed to be a business combination.

All business combinations are to be accounted for using the purchase method of accounting. The pooling-of-interests method is no longer acceptable.

Where it exists, Goodwill, defined as the excess of the cost of an acquired entity over the net of the amounts assigned to acquired assets and assumed liabilities, is to be recognized. Other acquired intangible assets are to be separately recognized if: (1.) they arise from contractual or other legal rights, regardless of whether those rights are transferable or separable from the acquired enterprise, or (2.) in cases where they do not arise from such contractual or legal rights, only if they are separable, that is, capable of being separated or divided from the acquired enterprise.

A lengthy list of illustrative intangibles which are deemed to be distinguishable from Goodwill has been compiled by the FASB. Among the listed intangible assets used by media and technology entities are: trademarks; tradenames; newspaper mastheads; noncompetition agreements; customer lists; customer and supplier relationships; video, audio and music materials; licensing and royalty agreements; advertising contracts; lease agreements; franchise agreements; operating and broadcast rights; employment contracts; and Internet domain names. Statement 141 specifically provides that the value of an assembled workforce of at-will employees acquired in a business combination is to be included with Goodwill.

When reporting a business combination, notes to the financial statements must disclose specific information where it is significant. For intangible assets subject to amortization: (1.) the total amount assigned and the amounts assigned to major intangible assets, (2.) the residual value, and (3.) the weighted average amortization period by major intangible asset class. Similarly, for nonamortized intangible assets: (1.) the total amount assigned and (2.) the amount assigned to any major intangible asset class. In the case of Goodwill: (1.) the total amount of acquired Goodwill, (2.) the amount that is expected to be deductible for tax purposes, and (3.) the amount of Goodwill by reporting segment.

Goodwill

Goodwill should not be amortized but should be tested for impairment annually at the reporting unit level. A presumption that the current Fair Value (Value) of a unit exceeds its carrying amount, is permitted if the following criteria have been met within the year: (1.) the unit's assets and liabilities have not changed significantly, (2.) the previous computation of the reporting unit's Value exceeded the carrying amount by a substantial margin, and (3.) no adverse events have occurred. Under these circumstances, this presumption may obviate the need for impairment testing.

By contrast, the Goodwill of a reporting unit should be tested for impairment between annual tests in the following instances: (1.) an event occurs that would likely reduce the Value of a

reporting unit below its carrying amount, (2.) an expectation arises that a reporting unit will be sold or disposed, or (3.) the value of a significant asset group within a reporting unit is questioned.

The test used to measure the impairment of Goodwill has two parts. First, the Value of a reporting unit is compared to its carrying amount. If the Value of the reporting unit is greater than its carrying amount, the second step is not required. In the second step, the implied Value of Goodwill is determined by establishing the value of all other assets of the reporting unit and comparing this amount to the reporting unit's Value. The difference in these amounts is the implied Goodwill. If the carrying amount of Goodwill exceeds its implied Value, an impairment loss must be recognized equal to the excess.

Other Intangible Assets

A recognized intangible asset should be amortized over its anticipated useful life. Such amortization must reflect any anticipated residual value associated with the asset. By contrast, an intangible asset with an indefinite useful life should not be amortized until its life can be determined. Both types of intangible assets should be tested for impairment annually or more frequently in cases where impairment may have occurred. Regarding these assets, the appropriate test consists of comparing the Value of the asset to its carrying amount. Where necessary, an impairment loss equal to the difference must be recognized.

For each accounting period, financial statement notes should contain related disclosures. For intangible assets subject to amortization: (1.) the total gross carrying amount and accumulated amortization, and those amounts by major class of intangible asset, (2.) total amortization expense for the period, and (3.) aggregate amortization expense for each of the following five years. For those intangible assets not subject to amortization: (1.) the total carrying amount, and (2.) the carrying amount for each major intangible asset class. For changes in the carrying amount of Goodwill: (1.) the amount of Goodwill acquired, (2.) the amount of impairment recognized, and (3.) the amount of Goodwill included in disposition gains or losses.

Implications for Media and Technology Businesses

Clearly these pronouncements radically increase the reporting requirements and the associated responsibilities associated with intangible asset accounting. This generalization is particularly true in industries which rely principally upon such assets. The new requirements that acquired intangible assets be separately identified, valued upon acquisition, and monitored thereafter for possible impairment, place a heavy burden upon entities which have engaged in extensive transaction activity in recent years, which contemplate such transaction activity, or which make use of literally hundreds of such assets. The recurring need to monitor and test intangible asset values will require that the financial accounting function become increasingly involved with the operational aspects of such businesses.

Industries in which intangible asset values routinely fluctuate in response to competitive pressures, advertising cycles, the equity markets, demographic trends, audience tastes, and governmental actions, to name a few of many possibilities, will be challenged to comply with these standards. Indeed, the complex and recurring valuation issues which arise as a result of the FASB's action will challenge media and technology businesses for the foreseeable future.

For more information: <http://accounting.rutgers.edu/raw/fasb/map/index.html>

Appendix: FASB Intangible Asset List

Marketing-Related Intangible Assets

- (1) Trademarks, tradenames
- (2) Service marks, collective marks, certification marks
- (3) Trade dress (unique color, shape or package design)
- (4) Newspaper mastheads
- (5) Noncompetition agreements

Customer-Related Intangible Assets

- (1) Customer lists
- (2) Order or production backlog
- (3) Customer contracts and the related customer relationships
- (4) Noncontractual customer relationships

Artistic-Related Intangible Assets

- (1) Plays, operas and ballets
- (2) Books, magazines, newspapers and other literary works
- (3) Musical works such as compositions, song lyrics, advertising jingles
- (4) Pictures and photographs
- (5) Video and audiovisual material, including motion pictures, music videos, and television programs

Contract-Based Intangible Assets

- (1) Licensing, royalty, standstill agreements
- (2) Advertising, construction, management, service or supply contracts
- (3) Lease agreements
- (4) Construction permits
- (5) Franchise agreements
- (6) Operating and broadcast rights

Appendix
(continued)

- (7) Use rights such as landing, drilling, water, air, mineral, timber cutting, and so forth
- (8) Servicing contracts such as mortgage servicing contracts
- (9) Employment contracts

Technology-Based Intangible Assets

- (1) Patented technology
- (2) Mask works
- (3) Internet domain names
- (4) Unpatented technology
- (5) Databases, including title plants.
- (6) Trade secrets including secret formulas, processes, recipes