

FASB Statements No. 141 and 142

Business Combinations and Intangible Assets

John Esch
Deloitte & Touche

Key Provisions - SFAS 141

- Defines a single approach for all business combinations - purchase accounting
- Disallows "pooling of interests" after June 30, 2001
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- Sets rules for determining and allocating the cost of an acquired entity and other contingent considerations
- Clarifies what is and is not a business combination

Key Provisions - SFAS 141 (continued)

- Recognition of more intangible assets
 - **Acquired intangible assets be recognized apart from goodwill if they meet either of two criteria – legal and separability**
 - **Goodwill includes those intangibles that do not meet the legal/separability requirement**
 - **The majority of intangible assets continue to be amortized against earnings**
 - **Provides a list of examples of recognized intangible assets**
- Broadens disclosure requirements, especially in year of purchase
- Effective for all business combinations (except if two or more mutual enterprises after combining) initiated after June 30, 2001.

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Key Provisions - SFAS 141 (continued)

Intangible Assets –Examples

<u>Intangible Assets</u>	<u>Contractual?</u>	<u>Separable?</u>	<u>Recognize?</u>
• Inforce policies (VOBA)	Yes	Yes	Yes
• State licenses	Yes	Yes	Yes
• Agency force	Yes	Yes/No	Yes
• Reinsurance treaties (ceded)	Yes	No	Yes
• Reinsurance treaties (assumed)	Yes	Yes/No	Yes
• Product approvals, registrations	Yes	No	Yes
• Health provider contracts	Yes	No	Yes
• Customer Base (“walk-ins”)	No	No	No
• Customer lists, databases	No	Yes	Yes
• Workforce	No	No	No

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Key Provisions - SFAS 142

- Eliminates regular amortization of purchased goodwill
- Certain identifiable intangible assets will not be amortized
 - ***Intangible assets determined to have an indefinite useful life are not amortized***
 - ***No minimum and maximum presumptions for the useful lives of identifiable intangible assets exist***
- Requires amortization of recognized intangible assets that have a finite useful lifetime
- Requires allocation of all purchased assets and liabilities, including Goodwill, to "reporting units"

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Key Provisions - SFAS 142 (continued)

- Requires impairment testing procedures to Goodwill and other intangible assets with indefinite useful lives be applied at least annually
 - ***Tests to be applied at the reporting unit level on a fair value basis***
- Impairment test differs based on whether identifiable intangible assets are non-amortizing or amortizing
- Establishes extensive disclosure requirements for goodwill, recognized intangible assets and impairment losses

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Key Provisions - SFAS 142 (continued)

- Adoption requirements
 - ***For new acquisitions – initiated or completed after June 30, 2001 (must use purchase method)***
 - ***Apply the new rigorous purchase price allocation methodology***
 - ***Goodwill no longer amortized and is subject to new impairment rules***
- Existing goodwill
 - ***Continue amortization until adoption (January 1, 2002 for calendar year companies)***

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Key Provisions - SFAS 142 (continued)

Summary of Accounting for Intangible Assets

	Goodwill	Indefinite Useful Life	Finite Useful Life
Characteristic	Intangible not Meeting legal, separability criteria	No factor (legal, contractual, economic, other) limits useful life	Expected useful life is limited
Amortization	None	None	Over useful life
Impairment Test Methodology	Two-step test (fair value based)	One-step test (FV vs. BV)	One-step test (SFAS 121)
Timing of Test	Annually, or more frequently as circumstances indicate	Annually, or more frequently as circumstances indicate	When there is an indication that the asset may be impaired

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Key Provisions - SFAS 142 (continued)

Testing Goodwill for Impairment

- Identify reporting units ("RU")
- Allocate and perform annual impairment test
 - **Test: assets, liabilities, and goodwill to reporting units**
- Purchase price allocation two-step approach
 - **Perform interim impairment test if there is an indication that the reporting unit's fair value may be below its carrying amount**
 - **If goodwill is impaired, record impairment charge in income from operations**

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Key Provisions - SFAS 142 (continued)

Identify Reporting Units

- Goodwill is not subject to amortization, but tested for impairment at the reporting unit level
 - **Not necessarily the same level as segments reported in financials (may be at least one level below)**
 - **Required to drill down one level below the operating segment (referred to as a component) if certain criteria met**
 - **SEC continues to scrutinize segment reporting and will likely scrutinize determination of reporting units**

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Key Provisions - SFAS 142 (continued)

GW Impairment Testing - A Two-Step Procedure

Step 1

- Compare FV of reporting unit with carrying value amount (including goodwill)
 - **If greater, GW is not impaired and no further testing is required**
 - **If the fair value is less, proceed to Step 2**

Step 2

- Compare implied FV of GW to its carrying amount
 - **Record any excess of carrying value over implied FV as an impairment loss, and set carrying amount of GW to implied FV**
- Once written down for impairment, GW cannot be reinstated

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Key Provisions - SFAS 142 (continued)

GW Impairment Testing - A Two-Step Procedure (continued)

Step 2 (continued)

- "Implied FV" is calculated as if the RU has just been acquired, with the FV of the RU considered the "purchase price". Any excess of this purchase price over the FV of amounts assigned to assets and liabilities of the RU is the implied FV of GW for the RU
 - **Taken as a hypothetical acquisition at the valuation date**
 - **Assets and liabilities are stated at fair value**
 - **Implied FV of GW is equal to FV of RU less net assets "acquired"**
 - **This process allows unrecognized intangibles to be considered**
- Once written down for impairment, no future recovery of goodwill value may be recognized

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Two-Step Impairment Test Example

Step One:

Carrying value of reporting unit	\$	600
Fair value of reporting unit		500
Is goodwill impaired?		yes

Step Two:

Fair value of reporting unit	\$	500
Less: Allocation to all assets and liabs		<u>475</u>
Implied fair value of goodwill		25
Carrying value of goodwill		<u>100</u>
Impairment charge		75

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Key Provisions - SFAS 142 (continued)

Annual Impairment Test

- Annual goodwill impairment test may be performed any time during fiscal year provided test is performed at the same time every year (i.e., one time selection for each RU)
- Different reporting units may be tested for impairment at different times
- Subsequent to the initial determination, entity may presume current FV of a reporting unit exceeds carrying value if all of the following criteria are met:
 - **Assets and liabilities of reporting unit have not changed significantly**
 - **Previous computation of FV substantially exceeded carrying amounts**
 - **No adverse events that would indicate a likelihood that current FV has fallen below carrying amount**

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Key Provisions - SFAS 142 (continued)

Interim Impairment Test

- May be required between annual tests if changes occur that more likely than not would reduce FV of RU
- Examples cited include:
 - **Adverse changes in legal factors, regulation, competition, business climate, personnel**
 - **A “more-likely-than-not” expectation exists that a reporting unit (or significant portion) will be sold or otherwise disposed of**
 - **A significant asset group is tested under FAS 121/144**
 - **A subsidiary recognizes an impairment loss in its stand-alone GAAP financial statements**

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Summary

Impact - More Judgment

- Significant judgments required for entities with subsequent acquisitions
 - **Which intangibles must be recorded separate from goodwill, at what value, and the appropriate life**
 - **Identification of reporting units**
 - **Allocation of goodwill to existing business units if the newly acquired business is to be integrated into existing businesses**
 - **Appropriate methods and assumptions used to measure impairment prospectively. During transitional testing, unsupportable GW gets written off without hit to operating earnings**
- FASB has provided very little guidance on how to make these judgments

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