

FASB 141 and 142

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Vanessa Brown Claiborne

Marc Katsanis

Chaffe & Associates, Inc.

220 Camp St.

New Orleans, LA 70130

504-524-1801

www.chaffe-associates.com

Statement 141

- All business combinations initiated after June 30, 2001 must be accounted for using the **PURCHASE METHOD**
- Eliminates Pooling-of-Interests method of accounting

Statement 142

Goodwill and other intangible assets with indefinite lives are no longer amortized over their estimated useful life (or randomly selected period) but are subject to an **IMPAIRMENT ASSESSMENT** by applying a **FAIR VALUE TEST**.

Fair Value

The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

The ability of a controlling shareholder to benefit from synergies and other intangible assets that arise from control might cause the fair value of a reporting unit as a whole to exceed its market capitalization.

Business Combination

- An entity acquires net assets that constitute a business
- An entity acquires controlling equity interests of one or more entities
- One or more entities are merged or become subsidiaries (not already under common control)
- One entity transfers net assets or its owners transfer their equity interests to another
- All companies transfer their equity interests to a new entity “roll-up”

Not a Business Combination

- Joint venture
- Acquisition of equity interests of minority shareholders of a subsidiary
- Transfers of net assets or exchanges of shares between entities under common control

Identifying the Acquirer

- Relative voting rights
- Largest minority voting interest
- Board of Directors
- Senior management
- Public company price premium

Timing

- Calendar year end companies-January 1, 2002
- Noncalendar year end companies-Beginning of FY starting in 2001 or 2002

Transition for a Calendar Year-End Company -Andersen Executive Summary July, 2001

| | Until 12/31/01 | On 1/1/02 |
|--|----------------|-----------|
| Amortize: | | |
| Goodwill (positive and negative) existing at June 30, 2001 | Do | Don't |
| Goodwill (positive and negative) acquired after June 30, 2001 | Don't | Don't |
| Intangible assets with indefinite lives existing at June 30, 2001 | Do | Don't |
| Intangible assets with indefinite lives acquired after June 30, 2001 | Don't | Don't |
| Impairment of Goodwill and Indefinite-Lived Intangible Assets: | | |
| Goodwill — old method | Do | Don't |
| Goodwill — new method | Don't | Do |
| Intangible assets with indefinite lives — old method | Do | Don't |
| Intangible assets with indefinite lives — new method | Don't | Do |
| Limit Intangible Asset Lives to 40 Years: | | |
| Intangible assets existing at June 30, 2001 | Do | Don't |
| Intangible assets acquired after June 30, 2001 | Don't | Don't |

Acquired Intangible Assets

Recognize Separately if:

- Obtained through contractual or other legal rights
- Can be sold, transferred, licensed, rented or exchanged

Finite vs. Indefinite life

An acquired intangible asset (other than goodwill) with an indefinite useful economic life should not be amortized (regardless of whether it has an observable market) until its life is determined to be finite

Separable intangible assets that have finite lives will continue to be amortized over their useful lives (subject to FASB 121 Accounting for the impairment of long-lived assets)

Implementation

1. Assess the effect
2. Disclose the Effect-August 14, 2001
3. Adopt the new rules-January 1, 2002 (perform step 1 of the impairment test within 6 months)
4. Ongoing requirements

I. Assess the Effect

- Reclassify any identifiable assets that were valued separately at the acquisition date but have been presented as goodwill
- Reclassify existing intangible assets into goodwill that do not meet the new criteria for recognition apart from goodwill.

II. Disclose the Effect-SEC Registrants SAB 74

- Description of the new standards
- Effect on future financial statements
- Whether the company will recognize an impairment charge

Example of SAB 74 Disclosure

- In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets*, effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill [and intangible assets deemed to have indefinite lives] will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives.
- The Company will apply the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of 2002. Application of the nonamortization provisions of the Statement is expected to result in an increase in net income of \$XX (\$YY per share) per year. During 2002, the Company will perform the first of the required impairment tests of goodwill and indefinite lived intangible assets as of January 1, 2002 and has not yet determined what the effect of these tests will be on the earnings and financial position of the Company.

III. Adopt the New Rules

- Identify reporting units
- Assign all goodwill to the reporting units based on the following:
 - where the acquired operations are assigned
 - how the reporting units will benefit from the synergies of the acquisition
- Perform impairment test

Reporting Unit

- SFAS 131, Disclosures about Segments of an Enterprise and Related Information-Operating Segment is a component of a business that earns revenue and incurs expenses, whose operating results are regularly reviewed by the chief operating decision maker to assess performance and allocate resources and for which discrete financial information is available.
- If all components of an operating segment are economically similar or if no discrete component level financial information exists, the reporting unit is the operating segment.

2 Step Impairment Test

1. Compare estimated fair value of each reporting unit to the carrying amount of the unit. If $FV < \text{Carrying amount}$, then Step 2.
2. Allocate reporting unit's estimated fair value at the valuation date to assets and liabilities (including goodwill). If fair value of goodwill is $< \text{Carrying amount}$, then report impairment loss.

Classification of Loss

- Impairment loss recognized at initial adoption of 142 is recorded as a cumulative effect of a change in accounting principle
- Thereafter, impairment expenses are an operating expense

IV. Ongoing requirements

- Set up amortization schedule for identifiable intangible assets with determinable lives
- Monitor reorganizations and business disposals for their effect on goodwill impairment
- Retain documentation

Frequency of Impairment Testing

- At least annually (Anytime in the year, different reporting units can be assessed at different times of the year)
- If an event occurs or circumstances change that more-likely-than-not reduce the fair value of the reporting unit below its carrying value or reduce the fair value of an indefinite lived intangible asset below its book value.

Examples of Impairment Events

- Change in legal factors
- Change in business climate
- Adverse action by a regulator
- Unanticipated competition
- Loss of key personnel

Overall Effect on Company

- Offsetting of unrecorded goodwill against impaired goodwill within a reporting unit is appropriate
- Not allowed to net an impairment in one reporting unit against increases in fair value in other reporting units
- Any subsequent reversal of a previously recognized impairment loss is prohibited

SEC Oversight

- Number of reporting units (smaller number of units allows you to net)
- Allocation of purchase price to reporting units (initially assign goodwill to a poorly performing unit to clear impairment off the books) (thereafter assign goodwill to a unit with increasing fair value-avoids impairment loss)
- Allocation of purchase price among intangibles (overallocation to goodwill lowers future amortization expense)

Disclosure-141

- Name and description of acquired company(ies) and % of voting share acquired
- Reason for the acquisition
- Condensed balance sheet showing amounts assigned to each major asset and liability
- Amount assigned to amortizable intangible assets and amortization period
- Total goodwill and amount that is expected to be tax deductible

(Above list does not include all factors)

Disclosure-142

- Amortizable assets-Carrying amount, accumulated amortization, amortization expense, estimated amortization expense for the next five fiscal years
- Goodwill-amount of goodwill acquired, amount of impairment loss recognized
- Impairment loss-Description of the asset and facts and circumstances leading to impairment, amount of the loss and method for determining fair value

Nortel Networks Corporation: 2001 Second Quarter 10Q

As part of our review of financial results during the three months ended June 30, 2001, we performed an assessment of the carrying values of intangible assets recorded in connection with our various acquisitions. The assessment was performed in light of the significant negative industry and economic trends impacting both our current operations and expected future growth rates, and the adjustment of technology valuations. The conclusion of that assessment was that the decline in market conditions within our industry was significant and other than temporary. As a result, we recorded a \$12,422 write down of intangible assets in the three months ended June 30, 2001, based on the amount by which the carrying amount of these assets exceeded their fair value. The write down is primarily related to the goodwill associated with the acquisitions of Alteon, Xros, and Qtera within the network infrastructure segment and the acquisition of the 980 NPLC Business within the photonics components segment. This charge was in addition to the ongoing amortization of intangibles of \$1,924 in the second quarter of 2001, as previously discussed above.

Example continued

Fair value was determined based on discounted future cash flows for the businesses that had separately distinguishable intangible asset balances and whose operations had not yet been fully integrated into Nortel Networks. The cash flow periods used were five years, the discount rate used was 20 percent, and the terminal values were estimated based upon terminal growth rates ranging from 5 to 11 percent.

The assumptions supporting the estimated future cash flows, including the discount rate and estimated terminal values, reflect management's best estimates. The discount rate was based upon Nortel Networks weighted average cost of capital as adjusted for the risks associated with the operations.

There was no impairment in enterprise level goodwill during the three month period ended June 30, 2001. The Company has determined that the remaining intangible asset balances will continue to be amortized on a straight-line basis over the remaining useful lives established at the time of the related acquisition as the remaining useful life of these intangible assets has not changed.

Valuation

- Overview of Common Intangible Assets that Often Need to be Recognized Separately from Goodwill
- Valuation of a Reporting Unit's Enterprise Value
- Allocation of the Reporting Unit's Enterprise Value to Assets

Intangible Assets

Statement 141 defines intangible assets as assets (not including financial instruments) that lack physical substance.

Goodwill versus Other Intangibles

- The intangible asset acquired arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the the acquired entity or from other rights and obligations.
- If the intangible asset does not arise from contractual or other legal rights, it should be recognized as an asset apart from goodwill only if it is separable; that is, it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged.

Marketing-Related Intangible Assets

- Trademarks, trade names
- Service marks, collective marks, certification marks
- Trade dress (unique color, shape or package design)
- Newspaper mastheads
- Internet domain names
- Noncompetition agreements

Customer-Related Intangible Assets

- Customer Lists
- Order or Production Backlog
- Customer Contracts and Related Customer Relationships
- Non-Contractual Customer Relationships

Artistic-Related Intangible Assets

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

Contract-Based Intangible Assets

- Licensing, royalty, standstill agreements
- Advertising, construction, management, service or supply contracts
- Lease agreements
- Construction agreements
- Franchise agreements
- Operating and broadcast rights
- Use rights such as drilling, water, mineral, timber cutting and route authorities
- Servicing contracts such as mortgage servicing contracts
- Employment contracts

Technology-Based Intangible Assets

- Patented technology
- Computer software and mask works
- Unpatented technology
- Databases, including title plants
- Trade secrets, such as secret formulas, processes, recipes

Valuation of a Reporting Unit and
Allocation of the Value to the Unit's
Assets

Fair Value Standard

The amount, in terms of a currency, that a willing and able buyer would pay a willing and able seller for an asset.

Approaches to Estimating Fair Value

- **Market Approach:** Estimates an asset's value by analyzing the characteristics of recent sales of comparable assets
- **Income Approach:** Estimates an asset's value by determining the future cash flows to which the owner of the asset is entitled. This cash flow stream is discounted to the present by a rate that considers the time value of money and the uncertainty inherent in the asset.
- **Asset/Cost Approach:** Estimates an asset's value by determining the cost of replacing the asset with a comparable asset.

Application of Market Approach

- Valuation of Reporting Units: Find the pricing multiples (the most common multiples are price to earnings, price to cash flow after tax, price to equity and total capitalization to EBITDA at which companies in the same industry as the reporting unit recently sold.
- Valuation of Intangible Assets: The data needed to implement a market approach is rarely available because detailed information about the value of intangible assets in transactions is rare. (This could change once Statements 141 and 142 are implemented).

Application of Income Approach

- Valuation of Reporting Units: Do a projection of the reporting unit's future cash flows after allowances for capital expenditures and discount those cash flows back to the present at the appropriate rate.
- Valuation of Intangible Assets: Estimate the amount by which the intangible asset contributes to the reporting unit's cash flows reduced by any expenses that are necessary to maintain the intangible asset and discount those cash flows back to the present at the appropriate rate.

Application of Asset/Cost Approach

- Valuation of Reporting Units: This approach is usually applied by estimating the amount that would be available to an owner of the reporting unit after liquidating all of its assets and satisfying all liabilities.
- Valuation of Intangible Assets: Estimate the cost to purchase or recreate the intangible asset.

Which Value Approaches for Which Intangible Assets? *

| | Primary | Secondary | Weak |
|---|----------------|------------------|-------------|
| Patents and Technology | Income | Market | Cost/Asset |
| Trademarks and Brands | Income | Market | Cost/Asset |
| Copyrights | Income | Market | Cost/Asset |
| Information Software | Cost/Asset | Market | Income |
| Product Software | Income | Market | Cost/Asset |
| Distribution Networks | Cost/Asset | Income | Market |
| Core Deposits | Income | Market | Cost/Asset |
| Franchise Rights | Income | Market | Cost/Asset |
| Corporate Practices and Procedures | Cost/Asset | Income | Market |

* Circumstances may exist where credible answers may be derived contrary to the method preferences used.

Source: Valuation of Intellectual Property and Intangible Assets, Second Edition.

Example 1--Perform Impairment Test for Reporting Unit

Telecom Unit

This reporting unit is a manufacturer and distributor of telecommunications equipment.

Example 1--Perform Impairment Test for Reporting Unit (Continued)

Telecom Unit Original Allocation

| | (Values in \$ Millions) |
|-----------------------------|----------------------------|
| Current Assets | 10.00 |
| Property, Plant & Equipment | 25.00 |
| Patents, Trademarks | 45.00 |
| Goodwill | 20.00 |
| Total Assets | <u>100.00</u> |
| Less: Liabilities Assumed | <u>(20.00)</u> |
| Total Equity Value | <u><u>80.00</u></u> |

Example 1--Perform Impairment Test for Reporting Unit (Continued)

Telecom Unit Current Carrying Value

| | (Values in \$ Millions) |
|----------------------------------|----------------------------|
| Current Assets | 10.00 |
| Property, Plant & Equipment, net | 24.16 |
| Patents, Trademarks, net | 36.00 |
| Goodwill | <u>20.00</u> |
| Total Assets | 90.16 |
| Less: Liabilities | <u>(20.00)</u> |
| Total Carrying Value | <u><u>70.16</u></u> |

Example 1--Perform Impairment Test for Reporting Unit (Continued)

Step 1

Compare Telecom Unit Carrying Value of
\$70.16 million
to
Fair Value of
\$85 million

Example 1--Perform Impairment Test for Reporting Unit (Continued)

Step 1

Fair Value > Carrying Value

Therefore, there is no impairment loss.

Example 2--Value a Reporting Unit

Premium Brand Foods Unit

This reporting unit is a manufacturer of premium brand food products.

Example 2--Perform Impairment Test for Reporting Unit (Continued)

Premium Brand Foods Unit Original Allocation

| | (Values in \$ Millions) |
|-----------------------------|----------------------------|
| Current Assets | 10.00 |
| Property, Plant & Equipment | 25.00 |
| Trademarks | 90.00 |
| Distribution Channel | 30.00 |
| Goodwill | 20.00 |
| Total Assets | <u>175.00</u> |
| Less: Liabilities Assumed | <u>(60.00)</u> |
| Total Equity Value | <u><u>115.00</u></u> |

Example 2--Perform Impairment Test for Reporting Unit (Continued)

Premium Brand Foods Current Carrying Value

(Values in \$
Millions)

| | |
|----------------------------------|----------------------|
| Current Assets | 10.00 |
| Property, Plant & Equipment, net | 24.16 |
| Trademarks | 90.00 |
| Distribution Channel | 30.00 |
| Goodwill | 20.00 |
| Total Assets | <u>174.16</u> |
| Less: Liabilities | <u>(60.00)</u> |
| Total Carrying Value | <u><u>114.16</u></u> |

Example 2--Perform Impairment Test for Reporting Unit (Continued)

Step 1

Compare Premium Brand Foods Carrying
Value of

\$114.16 million

to

Fair Value of

\$110 million

Example 2--Perform Impairment Test for Reporting Unit (Continued)

Step 1

Carrying Value $>$ Fair Value

Therefore, Step 2 must be performed.

Example 2--Perform Impairment Test for Reporting Unit (Continued)

Step 2

(Values in \$
Millions)

| | |
|--|----------------------|
| Fair Value of Reporting Unit | 110.00 |
| Net Fair Value of Reporting Unit Assets and Liabilities | <u>95.00</u> |
| Implied Fair Value of Goodwill | 15.00 |
| Carrying Value of Goodwill | <u>20.00</u> |
| Impairment Loss to be Recognized | <u><u>(5.00)</u></u> |

Implementation Actions for Companies to Take

- Identify Reporting Units
- Perform a Goodwill Impairment Test
- Companies that have Many Reporting Units Should Consider Staggering the Impairment Tests Throughout the Year
- Important Dates: (Calendar Year Companies)
Adopt Rule: January 1, 2002
Deadline for Performing Step 1 of
Impairment Test: June 30, 2002
Deadline for Performing Step 2 of
Impairment Test: December 31, 2002

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