

NEW GOVERNANCE IN ACCOUNTING RULES CONCERNING GOODWILL AND INTANGIBLES (THE ANNUAL IMPAIRMENT TEST)

There are new governance and accounting rules for goodwill and intangibles.

- Generally Accepted Accounting Principles (“GAAP”) no longer require that purchased goodwill be amortized.
- New categories of acquired intangible asset values are to be separately recognized, including contractual and non-contractual customer relations, proprietary but unpatented systems, people subject to employment contracts, backlog, etc. in addition to the familiar intangible asset categories such as patents, brands and trademarks. Such value will only be recognized separately from goodwill if it arises from a legal right or, if not, it is separable—that is, it is capable of being sold (the “separability and transferability test”).
- Goodwill value on the balance sheet is to be the excess of intangible value over the aggregate of the identifiable intangible value described above. Hence, goodwill is a residual amount. By default it will include such intangible values as the value of an assembled work force of “at will” employees who are not bound by contract and, in large part, synergies because they may have no value if separated from the business.
- Goodwill is to be carried on the financial statements, with exceptions, at its fair value. Initial write-down (“impairment”) of goodwill to fair value will not go through the Income Statement, nor will it impact earnings per share (“EPS”), provided the adjustment is made in the first fiscal year commencing after January 1, 2002. Subsequent write-downs will impact EPS directly.
- The fair value of goodwill and useful life of other intangibles need to be assessed annually pursuant to an “Annual Impairment Test” to ensure that value is not impaired and estimated useful life remains realistic.
- All non-current intangible assets other than goodwill will need to be depreciated or amortized over their “useful life”, unless life is determined to be indefinite.

HOW WILL GOODWILL BE VALUED? IT'S WHAT'S LEFT OVER.

The valuation of goodwill on the balance sheet for purposes of the Annual Impairment Test is set out below. In essence, it is what is left over after properly valuing everything else.

Enterprise value of business (“reporting unit”) acquired (that is to say, value of 100% of the “reporting unit” before debt)

Less

Value of hard assets including equipment and real estate, working capital and financial assets

Less

Value of identifiable intangible assets including those related to marketing, customers, artistic endeavor and those based on contracts and technology

Equals

GOODWILL

Paralleling the method of valuing goodwill on the balance sheet, the matrix below sets out some of the more common valuation techniques that will guide the valuation process. These techniques will undoubtedly become much more sophisticated and refined over the next few years as they receive increasing attention.¹ The most important test of all is of course the “common sense test”, DCF notwithstanding.

¹See, for example, Valuation for Impairment Testing: The Financial and Accounting Professional's Guide to Valuing Reporting Units for Compliance with SFAS 142, Mercer Capital, 2001, and Valuation for Financial Reporting: Intangible Assets, Goodwill, And Impairment Analysis SFAS 141 and 142, Mard, Michael J.; Hatcher, James R.; Hyden, Stephen D.; Zyla, Mark L., 2002.

“NEW CATEGORIES OF ACQUIRED INTANGIBLE ASSET VALUES ARE TO BE SEPARATELY RECOGNIZED...”

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ASSET(S) BEING VALUED	COMMON VALUATION CONSIDERATIONS, TECHNIQUES & COMMENTARY
Enterprise value of business acquired – value of 100% of the entity before debt	Original purchase price; discounted cash flow (“DCF”) analysis; multiple of earnings; comparable transactions. DCF will likely dominate. Other relevant techniques are to be examined and reconciled to ensure a balanced result. Guideline company, comparable transactions and multiples implicitly reflect the goodwill, synergies and the like of other entities that may not be comparable. They can therefore be very misleading.
Hard assets such as: Equipment Real estate Working capital and financial assets	Value in use for equipment. Highest and best use for real estate- fair market value; value in use. Working capital and financial assets at their real (not nominal) dollar amount; generally according to GAAP.
Identifiable intangible assets such as patents, brands, trademarks, domain names, trade secrets and Product focused technologies and in-process R&D Software for internal use, proprietary systems, people “in place” subject to restrictive covenants and the like and Customer related intangibles such as, customer lists, backlog, frontlog, noncontractual relationships	DCF and incremental income approaches will likely dominate, taking into account premium pricing advantages, volume advantages, economies of scale of gross profit advantages, reduced cost or improved margin advantages flowing from the IP. Other relevant techniques are to be examined and reconciled to ensure a balanced result, including the “residual return on assets method”, the relief from royalty method, the reasonable royalty methods and market based comparables. Various replacement cost calculations. Other relevant techniques are to be examined and reconciled to ensure a balanced result, including DCF and incremental income/ cost approaches.
Goodwill	Goodwill is what is “left over”, and is a residual. However, it must also be valued directly to ensure it passes the common sense test. DCF will likely dominate. Other relevant techniques are to be examined and reconciled to ensure a balanced result, including multiple of earnings and comparable transactions. The key will be to identify the incremental income or cash flow attributable to goodwill.
Synergies	Synergies will need to be specified and valued with DCF methods. Comparable transactions and multiples can be misleading. Synergies will be included in goodwill in large part.

THE TEST IS NOT FAIR MARKET VALUE BUT FAIR VALUE

IP and identifiable intangibles are not valued at the highest price in an open and unrestricted market between informed, prudent parties dealing at arm’s length. Rather, they are valued at their *fair value* having regard for the unique future contribution they can make to the business in question. Generally, this will be higher than fair market value. The emphasis is on their unique contribution to the business in question and will capture in many cases what has been known as “value to owner”, though to be recognized on the balance sheet it must still pass the separable and transferable test. Clearly, this is a fairer value but a much more subjective one.

A detailed discounted cash flow model should most frequently be used to determine fair value. Mergers and acquisition (“M&A”) and corporate finance “street” knowledge plus traditional business valuation theory will be needed to ensure the valuation balances both market realities and the subtleties of the specific business.

EARNINGS WILL GO UP AS A RESULT

Everything else being equal, if there is no amortization of goodwill, expenses will go down and earnings will go up. On the other hand, the Annual Impairment Test will impose much stricter responsibility to review all intangible values annually and in times of rapid technological and other changes. The useful life of many intangibles may shorten and the amortization expense will rise.

The write-downs as a result of impairment will be part of normal earnings and will not be extraordinary or “below the line.”

Note that these new rules will harmonize North American earnings calculations and that the “pooling of interest method” for acquisitions is no longer allowed.

WHEN IS AN INDEPENDENT VALUATION OPINION REQUIRED?

In most cases, management will undertake the Annual Impairment Test, which will be reviewed by the auditors. As the auditors cannot prepare valuation opinions for their

“...MUCH STRICTER RESPONSIBILITY TO REVIEW ALL INTANGIBLE VALUES...”

audit clients², it will often be appropriate to involve an independent valuator.

Given the new direct focus on value and the breadth of considerations bearing on goodwill, investors will rely in part, and perhaps significantly, on the published balance sheet values. As a result, there will be a high liability associated with them. The valuations must not only be in the correct range, but must be prepared in accordance with the standards.

We expect it will be common practice for companies to retain independent valuation specialists to review management's reports and give opinions or second opinions in the following instances:

- In reviewing, developing or assisting in the development of the procedures and documentation to be undertaken by management.
- Where there is or there may be a material impairment and analysts, shareholders, lenders or other stakeholders place particular reliance on intangible asset values.
- Where management, the auditors, the Audit Committee or Board want a second opinion because the matter is controversial or where the possibility of an error might result in the release of materially misleading financial information.
- Where specialized skills or greater appearance of independence is required or simply out of an abundance of caution.
- Where there is a likelihood of third-party review or litigation.

It is not likely that underwriters or investment banks will undertake this work due to conflicts (perceived and actual) and the opportunity cost of trading these fees for larger transaction oriented fees.

Note also that any valuation for financial statement purposes and the Annual Impairment Test may also constitute a "prior valuation" requiring disclosure in various securities circumstances, including in the course of going private, fairness opinion and formal valuation related matters.

WHAT KIND OF INDEPENDENT OPINION IS APPROPRIATE?

Valuations, by their nature, can only provide a reasonable range of accuracy. Absolute precision is often not practical to achieve in a timely and economical fashion. An informal estimate, second opinion or review is much less expensive and less time consuming than a formal opinion and will generally be more practical and appropriate.

A full and formal valuation opinion is likely required only when the matter is contentious, when management have not prepared their own substantive analysis or formal opinion or when thorough documentation is critical.

WHO SETS THE STANDARD?

The Canadian Institute of Chartered Business Valuators ("CICBV") and the American counterpart organizations prescribe standards and procedures for formal valuation opinions, informal and second opinions, and procedural reviews. They reflect generally accepted valuation principles and practices. They address the disclosure and style required in a valuation report, substantive content and methodologies, and scope of work to support the opinion and related professional matters. There is large body of

supportive publications and jurisprudence bearing on these areas.

Undoubtedly, these standards and many of the related legal precedents will be applied in assessing the valuations themselves, Board governance practices, and the performance and liability of all the parties involved, including management, Boards, independent valuation specialists and auditors.

COORDINATION WITH MANAGEMENT AND AUDITORS

The independent valuator will not need to "reinvent the wheel". Except as noted earlier, it will almost always be appropriate to work cooperatively, though independently, with management and the auditors to ensure timely and economic results. Without losing objectivity, the knowledge base of management and auditors can be highly leveraged by the independent specialist. Generally, valuations will not be built from the ground up but rather will build on the preparatory and other work done by management and, indirectly, the auditors.

QUARTERLY AND ANNUAL PLANNING AND DOCUMENTATION

In reviewing a company's procedures for the Annual Impairment Test, it is critical that consistent valuation principles and templates be applied whenever financial information is released, quarterly and annually. Proper planning will ensure there are no surprises and the process is both efficient and cost effective

Good processes are integral to discharging the Board's role of overseeing, just as are other internal controls. It is essential that management document both the processes and the resulting valuation reports and that the Board and the Audit Committee approve them.

GOVERNANCE STANDARDS IN OIL AND GAS INDUSTRY ARE INSTRUCTIVE

The Annual Impairment Test for goodwill and the annual oil and gas reserve data evaluations are very similar conceptually and therefore the oil and gas governance/disclosure precedents are very relevant. The various provincial securities commissions and oil and gas interest groups support the Draft National Instrument No. 51-101, Standards for Disclosure for Oil and Gas Activities, for all but the largest public oil and gas companies. It requires annual disclosure and valuation of reserve data, including proven and probable reserves, fair value and related reserve asset measures.

The requirements of the oil and gas issuer and the related practical consequences are very similar to that which we would expect will evolve for issuers generally regarding goodwill, including: retaining an independent qualified evaluator to report to its board of directors; making all necessary data available to the independent qualified evaluator; developing templates and documentation standards to ensure timely, efficient quarterly and annual disclosure; and, ensuring the board committee to which the independent evaluator reports is comprised of appropriate competent independent members.

²The U.S. federal government has recently passed the *Sarbanes-Oxley Act*, which prohibits auditors from providing various non-audit service to audit clients, including appraisal and valuation services. The CICA issued draft rules on September 6, 2002 outlining similar restrictions and prohibiting "...valuation services for clients where the valuation involves matters that are material to the financial statements that will be subject to *audit or review* (italics added) and the valuation involves a significant amount of subjectivity".

"...COMMON PRACTICE FOR COMPANIES TO RETAIN INDEPENDENT VALUATION SPECIALISTS..."

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WHAT'S TO COME? REALISTIC PRICING/VALUATION PRACTICES AND PROTECTION OF SHAREHOLDER VALUE

With the introduction of these new rules, and the inevitable risk that process will overtake judgment, application of the "common sense test" will be increasingly important. In fact, in light of the increased reliance that will be placed on valuation data, the experience, judgment and street knowledge of independent directors will become even more important.

Use of historical market based data will be increasingly suspect if not reconciled to market declines and impairment write-downs between the historical reference date and the valuation / pricing date.

The new accounting rules and the fallout from the Enron and WorldCom debacles are bringing about stricter governance and financial statement reporting responsibilities. Directors, audit committees, management, securities dealers, investment bankers and, of course, auditors must now focus more carefully on balance sheet goodwill and other intangibles ... on their fair value.

A focus on the fair value of goodwill goes to the heart of the value of the enterprise and that is both a broad and vital responsibility. In fact, we believe the new rules and focus will lead not only to more credible financial reporting but also to more realistic pricing/valuation practices and protection of shareholder value.

Management, auditors, directors, valuers and other necessary specialists will need to work together to ensure the process and its results are consistent, transparent and reliable.

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WHAT'S NEW

OUR WEB SITE! www.coleandpartners.com

See our website to find out more about the services we provide, examples of recent assignments, our publications, profiles of our professionals and how to contact us.

RECENT FAIRNESS OPINIONS AND VALUATION ASSIGNMENTS INCLUDE:

The merger of Indigo Books & Music Inc. with Chapters Inc.; acquisition of Pacifica Papers Inc. by Norske Skog Canada Limited; Ford Motor Company of Canada vs. Ontario Municipal Employees Retirement Board et al; merger of eDispatch.com Wireless Data Inc. and Air IQ Inc.

SPEAKING OF...

"Post-acquisition projections and the impact on the deal"; workshop presented by Scott Davidson & Andrew Harington at the M&A Valuation for CFO's annual conference, sponsored by Federated Press, in Toronto during the end of September.

"Establishing discount rates, capitalization rates and valuation multiples"; Vivian Alterman will be presenting on this topic at the M&A Valuation for CFO's annual conference, sponsored by Federated Press, in Toronto during end of September.

WRITING ABOUT ...

"Accounting of Profits Calculations in Intellectual Property Cases in Canada" and "Damages Calculations in Intellectual Property Cases in Canada" by A. Scott Davidson, Stephen R. Cole and Alexander Stack were published in the Canadian Intellectual Property Review.

"Partners in dual roles", written by Stephen Cole and Andrew Harington appeared in the May issue of CA Magazine.

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