Article Title: ARCHIVE | Criteria | Financial Institutions | Finance Companies: Finance Company Rating Methodology: The Treatment of Intangible Assets with a Focus on Goodwill Data: As part of its credit analysis of finance companies, Standard & Poor's assesses the impact that intangible assets have on a company's balance sheet and income statement and its resulting credit ratios. This article addresses how intangibles, both identifiable and unidentifiable, are treated according to generally accepted accounting principles (GAAP) and for tax purposes in accordance with the IRS ruling on intangibles adopted in early 1994. A discussion of how both the GAAP and tax accounting rules are incorporated into Standard & Poor's treatment of finance company intangibles follows. Standard & Poor's thought process and analytical/qualitative treatment of finance company intangibles, with an emphasis on acquired goodwill, is subsequently detailed. Finally, a summary of the Financial Accounting Standards Board's (FASB) recent decision to abolish pooling and require purchase accounting for business combinations by 2001 follows. Intangible Assets: U.S. GAAP Treatment Under Accounting Pronouncement Board (APB) 17 According to U.S. GAAP, specifically APB 17, intangible assets are defined as long-lived legal rights and competitive advantages developed or acquired by a business enterprise. It should be noted that internally developed intangibles do not appear on the balance sheet. Intangible assets cover both internally developed intangibles as well as those acquired in a business combination and are categorized as long-term assets on the balance sheet. Intangibles can also be classified as being either identifiable or unidentifiable. Identifiable intangibles include patents, copyrights, franchises, and trademarks and can be separately acquired or sold. Their ease of identification also implies a determinate life. By contrast, unidentifiable intangibles, which include organizational costs, proprietary processes and, most notably, goodwill, do not have a definite life and are inseparable from other assets of a company. For Standard & Poor's discussion purposes, it is helpful to delineate whether or not an intangible asset is identifiable or not identifiable, as the GAAP accounting treatment simplistically divides intangibles into these two distinct classifications. Under APB 17, all intangibles must be amortized over their estimated useful lives, with the maximum being 40 years. The amortization amount each period is usually on a straight-line basis and is charged to income over its estimated useful life, again not to exceed 40 years. The key issue here is that the useful life that is determined and utilized is only an estimate, and this holds true for both identifiable and unidentifiable intangibles. Clearly, intangibles that are identifiable would have more accurate estimates, hence the term identifiable. Identifiable intangibles often have an average life in the five- to 10-year range. By contrast, unidentifiable intangibles, in theory, have an unlimited useful life. In this way, defining its estimated useful life in years for amortization purposes is even more discretionary. The amortization period of purchased goodwill is typically longer than the average life of identifiable intangibles, and could very well extend out to 40 years . The amortization period used is important since it determines the magnitude and timing of the charge taken as an expense to the income statement. However, it is important to note that this noncash charge ultimately reduces bottom-line "book" earnings but does not affect company cash flow. As a result, profitability ratios such as operating margin calculations and earnings-per-share numbers are lower, but cash flow ratios remain unaffected. Intangible Assets:Tax Treatment Prior to 1994, only certain identifiable intangibles, primarily intangibles related to the publishing industry and brand names, were depreciable for tax purposes under Section 197 of the Tax Code. The IRS two-part test that applied required that an acquired intangible asset be held for use in a trade or business or for the production of income, and that the taxpayer demonstrate a limited useful life for the intangible. Hence unidentifiable intangibles, notably goodwill associated with acquisitions, was never tax-deductible. It was not until late 1993 that the IRS revised Section 197 of the Tax Code to include purchased goodwill arising from an acquisition completed after Aug. 10, 1993. This legislation was enacted by Congress as part of the Omnibus Budget Reconciliation Act of 1993. Accordingly, this type of goodwill is referred to as "new goodwill." However, purchased goodwill arising from pre-Aug. 10, 1993, or "old goodwill," was not grandfathered in by the IRS and hence is still not deductible for tax purposes. As such, under the revised Section 197, "new goodwill" was to be amortized for tax purposes on a straight-line basis over 15 years. The full tax deductibility of goodwill arising from the acquisition of a target company post-Aug. 10, 1993, easily translates into a favorable acquisition environment. Acquisition activity over the past several years has indeed heightened for many reasons, including growing core business to reach scope and scale. Acquisitions are as likely to be done for cash rather than stock since goodwill generated via an acquisition that utilizes purchase accounting results in a tax deduction of a meaningful magnitude. The generation of tax losses invariably has a significant value in the form of future tax savings to the newly combined company, resulting in real cash flow savings; this is the essence of the marginal tax benefit to the acquirer. A stock-for-stock merger, in contrast, utilizes pooling accounting and does not result in the generation of goodwill and its resultant tax benefit. Standard & Poor's Finance Company Treatment Of Intangibles: A Multi-Faceted Approach Standard & Poor's treatment of finance company intangibles is multifaceted and employs a combination of ratio analysis, analytical judgment, and criteria issues. The approach considers GAAP accounting standards and tax code rules discussed above, overlays finance company criteria arising from the finance company rating methodology profile (RAMP), and considers overall Standard & Poor's corporate criteria. Standard & Poor's general position has been to give more credit to intangibles that are identifiable. These include customer lists and trademark or brand value. Historically, Standard & Poor's did not give any equity credit to unidentifiable intangibles, namely, purchased goodwill, and very little credit to core deposit intangibles and credit card intangibles. Standard & Poor's more recent position is to also give less credit to credit card premiums than purchased goodwill arising from an acquisition. This is because credit card accounts can very easily close at any point in time, especially as consumers have taken advantage of the many incentives that credit card companies offer through balance transfer programs. At least with acquisition assets, the assets cannot disappear quite as easily. From a purely quantitative viewpoint, the greatest impact that intangibles have on a company's financial statements is in how they affect the financial ratios factored into Standard & Poor's finance company credit assessment. Standard & Poor's directly incorporates the accounting standards promulgated by GAAP into its financial statistics through the deduction of goodwill in the leverage calculation to arrive at a measure of tangible leverage. Other intangibles are not subtracted out in the calculation. In assessing a finance company's creditworthiness, Standard & Poor's employs a number of tangible leverage ratios as follows: Debt to tangible equity Debt to tangible equity plus reserve Debt to tangible equity + debt (capital) Leverage is then accordingly evaluated in the context of Standard & Poor's leverage guidelines for finance companies. The leverage model assigns a generic risk-weighting for the various subportfolios of a finance company and determines the appropriate level of capital as measured by debt to equity plus the loss reserve and basically ignores the level of intangibles. This approach, in effect, standardizes the magnitude and timing of the book amortization of goodwill, putting liberal and conservative management choices on an even footing. The end result allows for a more level playing field for compiling peer statistical income and leverage ratio comparisons. Although this provides a base line for leverage analysis, and gives zero equity credit as a first step, numerous qualitative considerations are then incorporated into the capital adequacy analysis in order to arrive at separate adjusted leverage ratios. Regarding goodwill, Standard & Poor's employs analytical judgment in evaluating management's choice of its scheduled goodwill amortization. The degree to which Standard & Poor's feels that the amortization of acquired goodwill is recognized too slowly and earnings are somewhat overinflated or leverage is understated, then Standard & Poor's will discount profitability rations and may be inclined to give less equity credit. This would be reflected in higher adjusted intangible leverage ratios by Standard & Poor's. These modified leverage ratios would then be judged against the finance company theoretical leverage model as well as similarly adjusted peer comparisons. It should be noted that this same type of analytical thought process would hold true for any other type of unidentifiable intangible, as well as all identifiable intangibles. Although these types of intangibles are not initially subtractions in the intangible ratio calculations like goodwill, Standard & Poor's may choose to incorporate any part of them into adjusted leverage ratio calculations. Standard & Poor's will opine on the adequacy of the time frame in which these intangibles are written off. This is an issue because of the eelection of the average life over which they are expensed, which is also highly discretionary. A second, but related, analytical adjustment involves the degree to which goodwill (or other intangibles) that is expensed each period affects the quality of earnings. Again, to the extent that company senior management chooses a longer estimated life, thereby underestimating the associated amortization expense and overstating corporate earnings, this action would not be looked upon favorably by Standard & Poor's. Accordingly, earnings would need to be readjusted to reflect a higher goodwill amortization expense, and hence lower net earnings. In other words, the quality of earnings becomes an issue given the flexibility that management has in its accounting choices and Standard & Poor's will accordingly make pro forma adjustments as necessary. Leverage ratios and margin calculations would, in turn, be normalized to incorporate a more acceptable amortization schedule. Higher leverage, or conversely lesser equity credit, and lower earnings ratios would be incorporated into the credit analysis. Conversely, to the extent that management is conservative in setting its goodwill amortization expense over a reasonable time frame, Standard & Poor's would view this action qualitatively as a favorable one. Overlaying this goodwill analysis is Standard & Poor's overall assessment of the economic viability or synergistic fit of the proposed acquisition. In this regard, Standard & Poor's is looking for whether or not the proposed acquisition provides business-line diversity or adds a new geographic presence. Additional considerations focus on whether there are economies of scale to the potential acquisition or if management already has expertise in this area. In short, a potential acquisition is evaluated in the context of whether or not its occurrence makes good business and economic sense. Once a proposed acquisition is deemed by Standard & Poor's as having some viable business merit , the economics of the acquisition are concurrently evaluated. This process is accomplished by thoroughly reviewing management pro formas, and challenging critical assumptions, projections, and sensitivity analyses that are often presented as a variant on payback analysis. Going one step further, Standard & Poor's periodically reviews these projections of expected performance against actual results as they are reported. An ongoing comparison of cumulative performance versus initial expectations established by the payback analysis enables Standard & Poor's to assess management's internal acquisition process skills, including setting projections and targets, cultural fit, and integration and assimilation. Also of concern is the level of due diligence performed in evaluating potential acquisitions. From all of this, Standard & Poor's will, over time, develop a general comfort level or credibility factor to apply to future acquisitions presented by senior management. Standard & Poor's will view goodwill for the size of an acquisition as being more appropriately valued, for example, where the consolidated entity will achieve attractive targeted rates of return in a relatively short time. Alternatively, where projected "synergies" from an acquisition do not result in the realization of expected savings and return on investment, Standard & Poor's will judge the value of the goodwill to be inappropriate and will not get comfortable with its valuation. From a tax viewpoint, Standard & Poor's finance company treatment of purchased goodwill recognizes the IRS distinction between "old goodwill" and the 100% tax deductibility of "new goodwill." While Standard & Poor's internal company spreadsheets which are used to generate financial ratios will deduct all goodwill to simplify calculations and capture GAAP treatment rather than tax aspects, Standard & Poor's will ascribe some favorable qualitative credit to the extent that tax benefits are generated and can be effectively utilized by the combined company resulting in a cash flow benefit to be realized. However, since pre-1994 purchased goodwill was not grandfathered in by the IRS, Standard & Poor's cannot give any qualitative credit to nontax deductible goodwill since there is no favorable cash flow impact. The above analysis also assumes that a finance company will not be penalized for a temporary spike in leverage if a significant amount of goodwill has been classified as being appropriately valued or a reasonable payback period has been established. Moreover, as previously discussed, to the extent that Standard & Poor's has become comfortable with a company's acquisition program because history has demonstrated that its projections have consistently been proven over time, a short-term uptick in leverage is more likely to be tolerated. An uptick in leverage, which implies a commensurate weakening of a company's capital position, will always be viewed in the context of a company's overall trend in leverage. Alternatively, where a finance company's leverage has historically been trending upward and is consistently bumping up against Standard & Poor's leverage comfort level, an incremental increase in leverage attributable to any goodwill will not be viewed positively. On Apr. 24, 1999, the FASB unanimously voted to eliminate the pooling of interests, requiring that only purchase accounting be used in mergers after Jan. 1, 2001. However, the board plans to continue taking comments on the formal proposal through the third quarter of 1999 and is expected to issue a final standard late in 2000. This action has been expected for quite some time. Merger activity utilizing pooling accounting will likely remain unabated until then. Thus far, FASB has determined that purchased goodwill should be amortized on a straight-line basis over its useful finite life. The amortization period is not to exceed 20 years. Goodwill is required to be reviewed for impairment no later than two years after the acquisition date if certain conditions are met. Purchased intangible assets other than goodwill are to be recognized separately as assets with an amortization period over the life of the finite asset not to exceed 20 years. Finally, intangible assets that are separable or potentially exchangeable with a finite life may be amortized over a period longer than 20 years. However, if they have indefinite lives, they may not be able to amortized. In this case, they should be reviewed for impairment using a fair market value approach.