PROPOSED SEC STAFF ANNOUNCEMENT

Topic: Use of the Residual Method to Value Acquired Assets Other than Goodwill

Date Discussed: September 29, 2004

FASB Statement No. 141, *Business Combinations*, states "(a)n intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights..." The SEC staff is aware of instances in which registrants have asserted that certain intangible assets that arise from legal or contractual rights cannot be separately and directly valued (hereinafter referred to as a "direct value method") because the nature of the particular asset makes it fundamentally indistinguishable from goodwill in a business combination (e.g., cellular/spectrum licenses, cable franchise agreements, etc.). Accordingly, some have applied a policy of assigning purchase price to all other identifiable assets and liabilities as provided in Statement 141, with the remaining residual amount being allocated to the 'indistinguishable' intangible asset. In these instances, there is either no goodwill recognized, or the amount of goodwill recognized uses a technique other than that specified in paragraph 43 of Statement 141. These methods have been referred to as "the residual method" of valuing intangible assets and have been used in the telecommunications, broadcasting and cable industries. Similar methods were used to allocate purchase price in acquisitions under APB Opinion No. 16, *Business Combinations*.

Some have asserted that the residual method provides an acceptable approach for determining the fair value of the intangible asset to which the residual is assigned, either because it approximates the value that would be attained from a direct value method, or because they believe that other methods of valuation are not practicable under the circumstances. Others have indicated that the residual method should be used as a proxy for fair value of the intangible asset in these situations, since the fair value of the intangible asset in question is not determinable. When it is or has been used in assigning purchase price, the residual method is also often used in impairment tests.

The SEC staff believes that the residual method does not comply with the requirements of FASB Statement 141. Paragraph 37(e) of Statement 141 requires intangible assets that meet the recognition criteria to be recorded at fair value. Paragraph 43 of Statement 141 states "the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed shall be recognized as an asset referred to as goodwill." The SEC staff notes that a fundamental distinction between other recognized intangible assets and goodwill is that goodwill is both defined and measured as an excess or residual asset, while other recognized intangible assets are required to be measured at fair value. The SEC staff does not believe that the application of the residual method to the valuation of intangible assets can be assumed to produce amounts representing the fair values of those assets. The SEC staff also notes that valuation difficulty does not provide relief from the requirements in paragraphs 37(e) and 39 of Statement 141 to separately recognize intangible assets at fair value apart from goodwill. Furthermore, the SEC staff notes that the types of assets being valued using the residual method by some entities are being valued using a direct method by other entities. Accordingly the SEC staff believes the residual method should no longer be used. Rather, a direct value method should be used to determine the fair value of all intangible assets required to be recognized under Statement 141. Impairment testing of intangible assets similarly should not rely on a residual method, and should instead comply with the provisions of FASB Statement No. 142, Goodwill and Other Intangible Assets.

Transition

Registrants should apply a direct value method to such assets acquired in business combinations completed after September 29, 2004. Further, registrants who have applied the residual method to the valuation of intangible assets for purposes of impairment testing shall perform an impairment test using a direct method on all intangible assets that were previously valued using the residual method no later than the beginning of their first fiscal year beginning after December 15, 2004. Impairments of intangible assets recognized upon application of a direct value method by entities previously applying the residual method should be reported as a cumulative effect of a change in accounting principle. Related deferred tax effects should also be reported as part of the cumulative effect of a change in accounting principle. Reclassification of recorded balances between goodwill and intangible assets immediately prior to adoption of this staff announcement is prohibited. Early adoption of a direct value method is encouraged.