New FASB Proposal May Impair Public Offerings

by Robert Willens • Lehman Brothers
and Robert W. Wood • San Francisco

The topic of goodwill and other intangibles has been in the news frequently this past year. First, there was *Newark Morning Ledger*, S.Ct., 4/20/93, in which the Supreme Court allowed amortization of customer-based intangibles (see "Does *Newark Morning Ledger* Spell Relief?," 1 *M&A Tax Rep't* 11 (June 1993), p. 1). Then Congress enacted Code Section 197 as part of the Revenue Reconciliation Act of 1993 (see "Intangibles Amortization Passes Amid Rate Increases," 2 *M&A Tax Rep't* 2 (September 1993), p. 7, and "Covenants Not to Compete After Section 197," 2 *M&A Tax Rep't* 4 (November 1993), p. 1).

Now, the Financial Accounting Standards Board ("FASB") will enter the intangibles foray, announcing shortly a rule that will likely make it more difficult for companies with goodwill to go public. Under current rules, a company is allowed to deduct from earnings the goodwill obtained through acquisitions, as long as it can show that future earnings will not cover an annual deduction for goodwill. Failing this, the goodwill has to be claimed against earnings over an up to 40-year period.

All Bets Off?

The FASB now intends to issue a rule to prevent all companies from including interest costs in determining whether profits will be sufficient to cover the amount of the goodwill. (See "FASB to Propose Rule Making It Harder For LBOs to Sell Their Stock to Public," *Wall St. J.*, 11/16/93, p. A6.) While interest costs today may seem a relative bargain compared to the high interest rates of a few years ago, it is generally perceived that this FASB change would make it substantially more difficult, if not impossible, for a company to write off the goodwill in one year. A closing of the one-time-write-down spigot would, in turn, make many public offerings more expensive.

Several companies this year have taken advantage of the goodwill write-off. Fort Howard Corp. took a nearly $2 billion write-down, and Pathmark Corp. took a $600.7 million write-off of its goodwill balance. In Pathmark's case, some investors reacted with surprise at the magnitude and appropriateness of the write-off. However, according to APB No. 17, the write-off was justifiable because the company had experienced several years of lackluster earnings. These earnings fell short of the estimates the company had originally made to support the amortization of goodwill created from its 1987 "mirror" acquisition.

Pathmark assessed the recoverability of its unamortized goodwill balance by projecting results of operations forward for 35 years (the remaining life of the goodwill) based on a five-year historical trend line of actual results. The forecast calculated projected revenue growth of only 0.5% per year, in part as a result of capital constraints that limited the company's ability to open new stores and remodel existing outlets. Based on these projections (which, interestingly, did not take into account the benefits the company might expect to reap from its recapitalization), the company concluded that operations conducted through the remaining life of the goodwill would yield a cumulative net loss of $155 million before goodwill amortization. Accordingly, Pathmark wrote off the remaining goodwill balance.

But the door for such write-downs has not already closed. In fact, even if the FASB proposal is approved, it would likely first be applied to 1995 financial statements. However, some observers suggest that even before this time frame, the mere presence of the FASB proposal will instill in federal regulators a more miserly view of write-downs.

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Indeed, the recent spate of large one-time write-downs are viewed as unusual. They have been said to have incited concern from the SEC.

Writing on the Wall?

With the FASB rule only now being proposed, the write-down question will surely not be settled for some time. Although many *M&A Tax Report* readers focus solely on tax rules, this may be one more area in which goodwill will involve large dollars hanging in the balance for a while. ■