Big changes came to how companies account for mergers and acquisitions when the FASB issued Statement of Financial Accounting Standards (SFAS) No. 141, “Business Combinations,” and No. 142, “Goodwill and Other Intangible Assets.” It’s been 19 months since then, and bankers are still trying to figure it all out as they use financial statements and ratios to analyze and evaluate a company.

The goal of these rules is to increase comparability in accounting for similar business transactions and to improve the transparency of information reported for goodwill. SFAS No. 141, which eliminates the “pooling-of-interests” method of accounting for business combinations, affects combinations entered into after June 30, 2001. SFAS No. 142, which eliminates amortization of goodwill and other indefinite-lived intangibles and instead requires these assets to be tested for impairment in value, is effective for fiscal years beginning after December 15, 2001 and for new business combinations occurring after June 30, 2001.

The effects of adopting the new goodwill accounting rules can be dramatic. AOL Time Warner reported a $54 billion goodwill impairment loss (which had a pre-adoption balance of $127 billion) and estimates a reduction in annual amortization expense of approximately $6.4 billion. On the less dramatic side, Coca-Cola Company reported a goodwill impairment loss of $926 million upon adopting SFAS No. 142 and estimates a reduction in annual amortization of approximately $210 million.

Effects on Financial Statements and Ratios

The adoption of SFAS No. 142 requires that an initial impairment assessment be performed on all goodwill as well as those intangible assets with indefinite lives. Any impairment loss from this initial assessment is recognized immediately as a cumulative effect of an accounting change on the income statement and a reduction in the carrying value of goodwill and other intangible assets on the balance sheet.

From the income statement perspective, the initial transition charge resulting from the impairment, net of taxes, will decrease income in the period of adoption. Future impairment losses will reduce income in the year the impairment occurs. On the other hand, net income in current and future years will increase with the elimination of amortization of

© 2003 by RMA. Bob G. Kilpatrick, Ph.D., CPA, and Nancy L. Wilburn, Ph.D., CPA, are professors of Accounting at Northern Arizona University, College of Business Administration, Flagstaff, Arizona.
goodwill and other intangible assets. From the balance sheet perspective, any initial impairment charge will reduce total assets. In addition, stockholders’ equity will be reduced by the flow-through effect of the initial charge to income, net of taxes, with a corresponding reduction in deferred tax liabilities (or an increase in deferred tax assets) from the resulting temporary difference in the tax basis and accounting carrying value of goodwill and other intangible assets.

From a cash flow perspective, there’s no real impact from the transitional impairment charge or the elimination of amortization for goodwill and other intangible assets, since amortization and impairment are noncash charges. However, an impairment charge may signal a potential reduction in future cash flows, since the determination of fair value used to calculate the amount of the impairment charge may be based on valuation models that incorporate current market prices of stock, expected future cash flows, or multiples of earnings or revenue. Figure 1 summarizes anticipated effects on categories of ratios in the year the new rules are adopted.

**Analysis of Coca-Cola and AOL Time Warner**

Most business combinations were already accounted for as purchases prior to the adoption of SFAS No. 141, so financial statements were affected more immediately by the transition treatment of goodwill and other indefinite-lived intangibles under SFAS No. 142 (for prior business combinations) and the elimination of amortization. The financial statements of Coca-Cola and AOL Time Warner over six months ending June 30, 2002, reveal the range of their impact on different companies.

Coca-Cola and AOL Time Warner both report on a calendar-year basis, so both adopted SFAS No. 142 in the first quarter of 2002. Coca-Cola reported a transition impairment charge of $926 million and estimated a total reduction in annual amortization of $210 million ($60 million from recorded goodwill related to consolidated subsidiaries and $150 million from goodwill related to equity-method investments). AOL Time Warner reported a transition impairment of $54 billion and a reduction in annual amortization expense of $6.4 billion.

Figure 2 compares selected ratios from the six-month periods ending June 30, 2002, and June 30, 2001. Because the comparability of the two periods is affected by the transition impairment charge and elimination of amortization, we have also recomputed pro forma 2002 numbers as if SFAS No. 142 had not been adopted.

Adopting SFAS No. 142 has a positive impact on profitability ratios, such as pre-tax profit margin, return on assets, and return on equity, due to the elimination of amortization. This impact can be seen in Figure 2, which compares Coca-Cola and AOL Time Warner’s actual profitability ratios for the six months ended June 30, 2002, to pro-forma ratios computed as if there had been no adoption of new accounting rules. The impact on AOL Time Warner’s profitability ratios is dramatic. For example, a comparison of actual pre-tax profit margin for AOL Time Warner shows an increase from (9.9%) in 2001 to 3.4% in 2002. However, this apparent improvement is driven by the adoption of the new accounting rules; when 2002 is restated to amounts based

<table>
<thead>
<tr>
<th>Ratio Category</th>
<th>Anticipated Impact</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity Ratios</td>
<td>None</td>
<td>New rules do not affect current assets or current liabilities.</td>
</tr>
<tr>
<td>Profitability Ratios (based on income before taxes)</td>
<td>Increase</td>
<td>Income before taxes increases due to the elimination of amortization of goodwill and other indefinite-lived intangibles, while total assets and stockholders’ equity decrease due to the transition impairment charge.</td>
</tr>
<tr>
<td>Debt Ratios</td>
<td>Increase</td>
<td>Stockholders’ equity decreases due to the transition impairment charge.</td>
</tr>
<tr>
<td>Cash Flow Ratios</td>
<td>Mixed</td>
<td>Although cash flows do not change either from the transition impairment charge or the elimination of amortization, cash flows relative to income will decrease (as the elimination of amortization increases income), while cash flows relative to assets will increase (as any transition impairment decreases total assets).</td>
</tr>
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on prior accounting rules, the pre-tax profit margin would have decreased to (12.4%).

Adopting new accounting rules for goodwill and other intangible assets causes an increase in the debt-to-equity ratio for both Coca-Cola and AOL Time Warner because of the flow-through effect of the transition impairment charge on stockholders’ equity. Although both companies show a small increase in the pro-forma ratio for 2002 compared to 2001 indicating a proportionately higher increase in debt than stockholders’ equity, the adoption of SFAS No. 142 causes a significant increase in AOL Time Warner’s actual ratio of 63.9% compared to the pro-forma ratio of 41.6%.

As expected, the impact of adopting SFAS No. 142 on cash flow measures was mixed. Coca-Cola’s impact on cash flow yield was a slight negative effect (pro forma 2002 versus actual 2002 ratios) versus a small positive effect on cash flow to assets. AOL Time Warner, on the other hand, shows a significant improvement in pro forma versus actual 2002 cash flow yield and a moderate improvement in cash flow to assets. It is important to remember when comparing these ratios that changes in the cash flow ratios are not from the cash flow numerator (which is not affected by adoption of the new accounting rules) but from the change in the denominator to which cash flows are compared.

**Summary and Conclusions**

Care must be taken in comparing prior-year results to current-year results without considering the impact of the accounting rule changes. Not taking SFAS Nos. 141 and 142 into account can create misleading results for comparisons both between companies and between different periods for the same company.

Contact Kilpatrick at bob.kilpatrick@nau.edu; contact Wilburn at nancy.wilburn@nau.edu