Second Quarter 2002

SRC Insights

FEDERAL RESERVE BANK OF PHILADELPHIA

A newsletter published by the Supervision, Regulation & Credit Department for the institutions that it supervises.

Volume 6 Issue 4

IN THIS ISSUE

SVP Commentary 1

In With the New: Accounting for Goodwill and Other Intangible Assets under FAS 142 2

Proposed Regulation W: New Guidance on Affiliate Transactions 4

Compliance Corner CC1

CIRCULATE TO:

☐ _____

☐ _____

☐ _____

☐ _____

SVP Commentary on…

Increased Transparency

by Michael E. Collins

In previous columns, I have discussed two "IT" topics—information technology and identify theft. Today, there is increased focus on yet another IT—increased transparency. The integrity of financial markets and the foundation of the banking system are built on public confidence. Therefore, increased transparency in accounting and disclosure is now a common mantra.

The recent increase in creative accounting, accounting irregularities, creative auditing, and outright fraud has brought accounting issues to the front page of almost every newspaper in America. Although the banking industry has not been in the headlines as much as other industries, there nonetheless have been both high profile and low profile issues that banking supervisors have had to deal with in recent months. A major focus has been on bank failures and losses attributed to improper accounting for securitizations and the treatment of special purpose entities (SPEs). SPEs are financial vehicles used to convert income-producing assets, such as loans, into cash. The debate continues in this

continued on page 6

In With the New: Accounting for Goodwill and Other Intangible Assets under FAS 142

by Eddy Hsiao, Senior Examiner

The fate of the pooling-of-interest method of accounting for business combinations was finally decided in mid-2001. In June 2001, the Financial Accounting Standards Board (FASB) issued Statement No. 141 (FAS 141), *Business Combinations*, which superseded APB Opinion No. 16, *Business Combinations*, and eliminated the use of the pooling method for all business combinations. The new guidance is effective for all business combinations initiated after June 30, 2001 and all purchase transactions consummated after June 30, 2001. In conjunction with the issuance of FAS 141, FASB issued Statement No. 142 (FAS 142), *Goodwill and Other Intangible Assets*, which superseded APB Opinion No. 17, *Intangible Assets*. FAS 142 became effective for companies with fiscal years beginning after December 15, 2001. Accordingly, for financial institutions application of FAS 142 became effective with the filing of the March 31, 2002 Call Report.

While the application of the basic provisions of the purchase method of accounting for a business combination has not changed significantly, the implementation of FAS 141 requires arduous price allocation, reporting unit identification, and separate identification and treatment of intangible assets other than goodwill with definite and indefinite lives. A discussion of all of these tasks is beyond the scope of this article. The purpose of this article is to provide a brief summary of FAS 142 and its implications for financial institutions.

Reflecting FASB's increased emphasis on measuring the fair value of assets and liabilities, FAS 141 and FAS 142 emphasize asset valuation as opposed to expense recognition.

FAS 142 vs. Opinion No. 17 and FAS 121

Reflecting FASB's increased emphasis on measuring the fair value of assets and liabilities, FAS 141 and FAS 142 emphasize asset valuation as opposed to expense recognition. Accordingly, FAS 142 eliminated the amortization of goodwill and indefinite-lived intangibles and focused instead on asset valuation and impairment. Instead of amortization of goodwill over a period not to exceed 40 years, FAS 142 introduced a two-step process to determine if goodwill is impaired and the amount of any impairment loss to be recognized. This assessment must be made annually.

To determine if goodwill is impaired, the fair value of the reporting unit that caused the goodwill to be generated (e.g., the bank that was acquired) is compared to the reporting unit's carrying amount plus the related goodwill. If the fair value is greater than the carrying amount, no further analysis is needed. If, however, the fair value of the reporting unit has dropped below its carrying value plus the related goodwill, goodwill impairment might have occurred. Then, in a more difficult assessment, the implied fair value of the reporting unit's goodwill is compared to the carrying value of the goodwill to determine any impairment. (See the example under "Testing for Impairment.")

Indefinite-lived intangible assets, which appear infrequently in banks, must also be tested for impairment annually. However, the impairment test for indefinite-lived intangibles is more straightforward and should be performed on an asset-by-asset basis rather than on the entire reporting unit.

FAS 142 also requires more extensive disclosure concerning goodwill and other intangible assets. The aggregate amount of goodwill must be presented as a separate line item in the statement of financial position (i.e., balance sheet) and goodwill impairment losses must be reported as a separate line item in the statement of operations (i.e., income statement). Additional narrative and tabular disclosures are also required in the financial statements.

The key differences between FAS 142 and the old rules are summarized below.

Effective Date and Transition to FAS 142

The provisions of FAS 142 are effective for fiscal years commencing after December 15, 2001. Therefore, goodwill and intangible assets that existed prior to July 1, 2001 would continue to be amortized until December 31, 2001. However, goodwill and indefinite-lived intangible assets that arose after June 30, 2001 would not be amortized, even though the company had not otherwise adopted FAS 142.

All calendar-year companies must adopt FAS 142 beginning on January 1, 2002. The first step of the impairment test—the fair value and book value comparison—must be performed within six months of the initial adoption of FAS 142. If losses are determined from the first step, the amount of impairment must be calculated using the second step as soon as possible, but no later than by year-end.

Testing for Impairment

Intangibles Other than Goodwill. Amortizable intangible assets, i.e., those with definite lives, will continue to be reviewed for impairment in accordance with FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Core deposit intangibles are such assets. Indefinite-

continued on page 8

Comparison of FAS 142 and Prior Rules

		FAS 142	Old Rules
Goodwill Amortization		Goodwill is no longer subject to amortization	Amortization is required under APB No. 17, but for a maximum period of 40 years
Goodwill Impairment Test Guidance		Impairment test, using a two-step process, must be done when events or circumstances occur that indicate that goodwill might be impaired, but not less than annually	Impairment is determined only after the occurrence of certain triggering events, per FAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*
Intangible Asset (IA)	**Definite-lived**	IA is amortized over the useful life without the constraint of the 40-year ceiling	IA is amortized over life, not to exceed 40 years
	Indefinite-lived	IA is separated from goodwill and ***individually*** tested for impairment	IA is normally included with goodwill, which is subject to amortization
Disclosure		More disclosure requirements	Less disclosure requirements

Proposed Regulation W: New Guidance on Affiliate Transactions

by William L. Gaunt, Assistant Vice President

In May 2001, the Board of Governors of the Federal Reserve System (the Board) announced three actions designed to strengthen and simplify regulation of banks' transactions with their affiliates. First, the Board proposed and asked for comment on new Regulation W to implement sections 23A and 23B of the Federal Reserve Act. Section 23A restricts loans by a bank to an affiliate and asset purchases by a bank from an affiliate. Section 23B requires that transactions between a bank and its affiliates be on market terms.

In its second action, the Board issued interim final rules, which became effective January 1, 2002, that place restrictions on inter-affiliate derivative transactions and intraday extensions of credit between banks and their affiliates. The comment period on both of these actions closed on August 15, 2001.

In the third action, the Board issued final rules granting several exemptions from sections 23A and 23B relating to loans and to purchases of assets.

The final Regulation W is not expected before mid-2002 at the earliest because of the large number of comments received and the complexity of the issues. Until Regulation W is finalized, all previously issued valid Board interpretations and staff opinions regarding sections 23A and 23B, together with the interim final rules on derivative transactions and intraday credit, will remain in full force and effect.

This article points the reader to some of the larger issues posed by the new affiliate transaction rules, provides a timetable for implementation of the new regulations and guides the reader to where the regulations and related information can be found.

New Regulation W - Why is it Needed?

Sections 23A and 23B of the Federal Reserve Act are key statutory protections against a bank incurring losses from its transactions with its affiliates. In effect, sections 23A and 23B restrict the ability of a bank to transfer to its affiliates the subsidy stemming from the bank's access to federal deposit insurance.

The adoption of a comprehensive, unified regulation implementing sections 23A and 23B is appropriate for several reasons. The new regulatory framework established by the Gramm-Leach-Bliley Act (the GLB Act) emphasizes the need for sections 23A and 23B to isolate banks from potential losses incurred by the newly permitted affiliates under the GLB Act. Also, the adoption of a comprehensive, unified regulation would simplify the interpretation and application of sections 23A and 23B, ensure that the statute is consistently interpreted and applied, and minimize burden to the extent consistent with the statute's goals.

Key Elements of Proposed Regulation W

Regulation W would replace the existing framework of Federal Reserve interpretations and informal staff guidance with an organized, category by category approach to sections 23A and 23B. It would consolidate the numerous findings by the Board that deal with how sections 23A and 23B apply to bank transactions and also make various changes to the existing rules. Certain of these changes are required by the GLB Act while others reflect an updated look at affiliate transactions including several proposed exemptions for specified transactions.

Some key issues addressed in proposed Regulation W are:

- credit exposure on intraday credit extensions by banks to their affiliates;
- credit exposure on derivative transactions between banks and their affiliates;
- new exemptions;
- treatment of financial subsidiaries;
- the so called "250.250" exemption permitting a bank to purchase loans from an affiliate;
- valuation of a bank's investments in and acquisitions of affiliates;
- collateralization of a bank's investment in debt securities (including commercial paper) of an affiliate; and
- application of sections 23A and 23B to U.S. branches and agencies of foreign banks.

Due to the broad scope of the proposed changes, as illustrated by the 120-page proposal and request for comment, this article will address only the first four issues in the above list.

Interim Final Rules on Intraday Credit and Derivatives

On January 1 of this year, in an action related to the issuance of proposed Regulation W, "interim final" rules required by the GLB Act became effective. These rules place restrictions on inter-affiliate derivative transactions and regulate intraday extensions of credit between banks and their affiliates. The designation "interim final" for the rules covering derivatives and intraday credit transactions stems from the fact that the rules became effective January 1, 2002 and will remain in place until further notice from the Board. In all likelihood, the rules will be adjusted in the future to reflect the comments solicited from the banking community, hence the "interim" designation. After the Board has considered the comments on the regulation and declares the final regulation effective, the derivative and intraday credit rules will become a part of Regulation W to create a single comprehensive regulation.

Intraday Credit. The interim final rules require that the bank have established policies and procedures for intraday credit. At a minimum, the bank must monitor and control its intraday credit exposure to each affiliate and all affiliates in the aggregate and ensure that extensions of intraday credit comply with section 23B (e.g., ensure that the risk management process for intraday credit is no less rigorous than the process that the bank employs for such transactions with third parties). These policies and procedures must be in place by January 1, 2002 for the exemption to apply.

Proposed Regulation W further provides that an intraday extension of credit is not subject to the quantitative limits or collateral requirements of section 23A if the credit extension arises in connection with the performance by a bank, in the ordinary course of business, of securities clearing and settlement transactions or payment transactions (for example, wire transfers, check clearing, and ACH transactions) on behalf of an affiliate. In other words, the intraday credit must not be intended to fund the affiliate, and the bank must have no reason to believe that the affiliate will have difficulty repaying the extension of credit in the ordinary course of business.

Finally, all intraday credit extensions that exist at the end of the bank's business day in the United States would become subject to section 23A at that time since they are no longer intraday extensions of credit but become overnight extensions of credit.

Derivative Transactions with Affiliates. Determining the appropriate treatment for derivative transactions under section 23A is a complex endeavor. Accordingly, the Board's interim final rule addressed only those provisions required to be implemented under the GLB Act, while the Regulation W proposal included requests for comment on a number of major issues related to derivative transactions. The interim final rules require that institutions adopt policies and procedures to monitor, manage and control credit exposures resulting from derivative transactions with their affiliates. At a minimum, the policies and procedures must provide for monitoring and controlling the credit exposure arising from the bank's derivative transactions with each affiliate and all affiliates in the aggregate and ensure that the bank's derivative transactions with affiliates comply with section 23B.

All intraday credit extensions that exist at the end of the bank's business day in the United States would become subject to section 23A at that time since they are no longer "intraday" extensions of credit.

Final Rules on Exemptions from Section 23A

In its third action dealing with affiliate transactions, the Board issued final rules effective June 11, 2001 that provide for three exemptions from

continued on page 10

"Increased Transparency"

continued from page 1

area relating to explicit or implicit performance guarantees arising from securitized assets. However, self-disclosure is emerging as a standard.

As businesses have grown more complex, so have the methods of accounting for their transactions. Since its formation in 1973, the Financial Accounting Standards Board (FASB) has issued 144 Financial Accounting Standards. This body of guidance has been supplemented by numerous FASB Interpretations, FASB Technical Bulletins, Emerging Issues Task Force Consensuses, and other authoritative accounting and disclosure guidance. Unfortunately, business complexity always leads accounting change, and in the temporary vacuum of guidance, creative accounting practices may be born.

Invariably, as accounting guidance has become more complex, loopholes are formed. Too often, in a misguided attempt to better serve their clients in today's high pressure competitive marketplace, some accountants look for the loophole in the accounting guidance, squeaking by on technicalities and on the margin, adhering to the letter but not the spirit of the "law." Alternatively, some clients pressure their accountants to turn a blind eye to practices on the margin, asking for the removal of staff who question or resist their requests.

Effective and transparent accounting and disclosure should emphasize the substance of a transaction over the form of accounting. While accountants and economists often debate the "economic value" of a transaction, selecting the accounting and disclosure approach that best describes the economic substance of the transaction but follows GAAP for valuation purposes might best serve all constituents.

The Role of the External Auditor

A common misconception is that the financial statements are the auditor's responsibility. The auditor's responsibility is to express an opinion on the financial statements. Accordingly, auditors plan and perform the audit to obtain *reasonable* assurance about whether the financial statements are free of material misstatement. This requires the auditor to use professional skepticism when considering management's assertions and representations and to obtain sufficient evidential matter to allow the auditor to express an opinion. Sufficient evidential matter is generally a sampling of documents and transactions, since a review of every transaction, document, asset, and liability would be cost and time prohibitive. Therefore, because of the nature of audit evidence and the concealment and/or collusion aspects of fraud, the auditor is able to obtain only *reasonable*, not absolute, assurance that material misstatements are detected.

> Selecting the accounting and disclosure approach that best describes the economic substance of the transaction but follows GAAP for valuation purposes might best serve all constituents.

The Role of the Bank Supervisor

Another misconception is that bank supervisors are responsible for detecting all fraud in a financial institution wherever it exists. The examination process is not designed to ferret out fraud; indeed, examinations rely to a significant degree on internal and external auditors to validate the accuracy of the financial data that are the raw material of the examination process.

The key objective of prudential supervision is to ensure that banks operate in a safe and sound manner, thereby maintaining stability and confidence in the financial system and reducing the risk of loss to depositors and the insurance funds. Effective supervision involves the collection and analysis of information about a bank's activities. However, like external auditors, bank supervisors cannot review every document and transaction. Accordingly, they assess whether bank management has established a strong system of internal controls that is consistent with the nature, scope, and scale of their business. It is this system of internal controls that provides assurance that financial reporting is accu-

rate, complete, and timely. Naturally, effective internal controls would also minimize the likelihood of and better ensure the detection of both fraud and error.

To address the risk that fraud places on the banking organizations that we supervise, bank examiners have been trained to identify red flags that might indicate the occurrence of fraudulent activity. Many of our examiners have received training to better enable them to trace financial transactions; recognize public company financial statement misrepresentations; use examination techniques designed to ferret out misrepresentations and distortions in financial statements; understand and be able to recognize indications of money laundering; recognize new types of white collar crime; and assess the adequacy of internal routines and controls to prevent fraud.

When fraud is suspected or detected, bank supervisors have processes to ensure that the fraudulent activity is reported to the proper authorities and that appropriate remedial action is taken. Tools at the examiner's disposal include the Suspicious Activity Reporting (SAR) system, the Board of Governor's Special Investigations Unit, and various levels of enforcement actions.

The Role of Bank Management

If external auditors and bank examiners are not responsible for the financial statements and are not responsible for detecting all fraud, then who is? Internal controls and the financial statements are management's responsibility. Consistent with the AICPA's Statements on Auditing Standards and Generally Accepted Auditing Standards, management is responsible for adopting sound accounting policies and for establishing and maintaining internal controls that record, process, summarize, and report transactions consistent with management's assertions embodied in the financial statements. Therefore, effective corporate governance is closely linked to accounting transparency.

Recent events surrounding the integrity of financial statements have resulted in increased emphasis on the "responsibility culture." There is a clear recognition that leaders of corporations have a special obligation to shareholders, employees, and the public. In the final analysis, fraud prevention may come down to the character of employees and customers.

Accounting Transparency and Market Discipline

The Federal Reserve has long supported sound accounting policies and meaningful public disclosure by banking and financial organizations with the objective of improving market discipline and fostering stable financial markets. The most recent proposal to amend the Basel Capital Accord recognizes the importance of market discipline as a supplement to effective bank supervision. Accordingly, the proposal would create three pillars to assess capital adequacy—risk-based capital (pillar 1), risk-focused supervision (pillar 2), and disclosures of risks and capital adequacy to enhance market discipline (pillar 3). This proposed approach to capital regulation signals that sound accounting and disclosure will remain important aspects of bank supervision since, without accounting transparency, market discipline will fail.

Disclosure does not come in a one-size-fits-all package. Prescriptive disclosure would create a statistical nightmare and a false sense of security for financial statement users. Rather, each company should disclose in plain English the information that it believes its stakeholders (whether regulators, supervisors, shareholders, or the general public) would want and need to know to evaluate the company's financial position, internal controls, and risk profile. For in fact, the inability of a company to articulate clearly and transparently the nature and risk of its activities is in itself an indicator that management might be assuming an inappropriate amount of risk. ■

The inability of a company to articulate clearly and transparently the nature and risk of its activities is in itself an indicator that management might be assuming an inappropriate amount of risk.

"Accounting for Goodwill" *continued from page 3*

lived or unamortizable intangible assets will not be subject to impairment testing under FAS 144. Instead, indefinite-lived intangibles must be tested for impairment individually when conditions warrant, but not less than annually. The impairment test is performed by comparing the individual intangible asset's carrying value to its fair value. If the fair value is less than the carrying value or book value, the difference is recognized as impairment loss.

Goodwill. Under FAS 142, goodwill impairment should be tested at least annually at the reporting unit level. For purposes of FAS 142, a reporting unit is an operating segment as defined in FAS 131, *Disclosures About Segments of an Enterprise and Related Information*, or one level below an operating segment. In general, a reporting unit is the lowest level of a company that earns revenue and incurs expenses, has discrete financial information available, and is reviewed regularly by the chief operating decision maker. Reporting units can be distinguished physically and operationally and for internal reporting purposes from other activities, operations, and assets of the entity. For financial institutions, each bank that files a Call Report would be considered a reporting unit. Nonbank subsidiaries of the holding company and the holding company itself are also reporting units.

The annual test may be performed at any time during the year, but must be performed at the same time each year. In addition, an interim test should be performed if an event occurs that likely would reduce the fair value of the reporting unit below its carrying value.

The two-step process for assessing any impairment of goodwill might occur as follows.

Step 1: Comparing the FV and BV of the Reporting Unit

If the reporting unit's fair value is greater than its book value including goodwill, no impairment has occurred and the analysis is complete. If the reporting unit's book value including goodwill is greater than its fair value, the goodwill must be assessed for impairment. This calculation can be best illustrated by the example below.

In many acquisitions, the resulting goodwill is recorded on the books of the parent company instead of being pushed down to the acquired entity when the parent company's controlling interest of the subsidiary is less than 80 percent. For purposes of this assessment, the goodwill on the parent company's books related to the acquisition is allocated to the reporting unit.

Step 2: Measuring the Amount of Impairment

The amount of impairment is determined by comparing the implied fair value of the goodwill and the book value of the goodwill. This is much more complex than step one testing, since all assets and liabilities of the reporting unit must be valued separately. The implied value of goodwill is calculated as the difference between the fair value of the reporting unit as a whole and the sum of

The Two-Step Impairment Test

Step 1:

	FV > BV	FV< BV
FV of Reporting Unit	$ 325,000	$ 265,000
BV of Reporting Unit (including $35,000 goodwill)	300,000	300,000
	$ 25,000	$ (35,000)
	Stop!!	**Go to Step 2**

Step 2:

Sum of FV of Tangible and Intangible Assets	$ 3,000,000
Sum of FV of Liabilities	(2,745,000)
Sum of FV of Net Assets	$ 255,000
FV of Reporting Unit from above	265,000
Implied FV of Goodwill	$ 10,000
BV value of Goodwill from above	35,000
Calculated Impairment	$ **25,000**

the individual fair values of its assets, net of the fair value of its liabilities.

Any impairment must be recognized in the period in which it is identified, and cannot be deferred. If the original goodwill was recorded on the parent's books, the impairment is also recorded on the parent's books and not on the books of the reporting unit.

Impact on Earnings and Capital Earnings. During the initial phases of the implementation of FAS 142, companies will likely report higher earnings since goodwill is no longer being amortized. However, future profitability might not be as predictable or consistent given the potential impairment charges that can be affected by many outside factors. Moreover, companies might have to provide additional budget for training and/or consulting fees to ensure an appropriate valuation is performed annually. Nonetheless, the overall financial information provided to stakeholders will be more relevant and reliable.

FAS 142 does not recognize the concept of temporary impairment. Accordingly, if a step-one assessment indicates impairment, no matter how temporary, the step-two assessment must be performed and any impairment must be recognized. In addition, FAS 142 impairment write-downs of goodwill and indefinite-lived assets cannot be recovered in subsequent periods. Therefore, so-called temporary impairments would be reflected permanently in a company's financial statements.

Consider the effects of September 11, 2001. The market capitalization (possibly one indicator of value) of many publicly traded companies plunged below the net book value of their assets. For FAS 142 purposes, any goodwill would likely be determined to be impaired, and would be required to be written down. After the stock markets adjusted to the external events and share prices again rose, the write-downs could not be recovered.

Capital. Since earnings are transferred to capital with closing entries, the impact on equity capital mirrors that on earnings. However, since goodwill is excluded from capital calculations for regulatory capital purposes, regulatory capital would be the same under both the new and old rules, excluding tax implications.

This can be demonstrated by the following example, using the goodwill information from the previous illustration.

continued on page 11

Tier 1 Capital Remains The Same: Goodwill Amortization Versus Impairment	**Opinion 17 (Old)**	**FAS 142 (New)**
Year 1:		
$35,000/40 years (assume no impairment)	$ 875	$ 0
Remaining Goodwill	34,125	35,000
Tier 1 Capital:		
Beginning equity	300,000	300,000
Earnings:		
(Assumed first year earnings of $40,000 before amortization or impairment)	39,125	40,000
Goodwill Deduction	(34,125)	(35,000)
Tier 1 Capital	$ 305,000	$ 305,000
Year 2:		
Assume $25,000 impairment	$ 875	$ 25,000
Remaining Goodwill	33,250	10,000
Tier 1 Capital:		
Beginning equity	339,125	340,000
Earnings:		
(Assume second year earnings of $30,000 before amortization or impairment)	29,125	5,000
Goodwill Deduction	(33,250)	(10,000)
Tier 1 Capital	$ 335,000	$ 335,000

"New Guidance on Affiliate Transactions"

continued from page 5

section 23A. The first of these exemptions exempts from section 23A's "attribution rule" loan proceeds used by unaffiliated bank customers to purchase securities or other assets from or through an affiliate of the bank. The Board has confirmed that section 23A does not apply to extensions of credit by a depository institution to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as the affiliate is acting exclusively in an agency or brokerage capacity, and the affiliate retains no portion of the loan proceeds. The Board has also specifically exempted from section 23A that portion of the loan that the affiliate might retain as a market-rate brokerage commission or agency fee for processing the transaction.

A similar exemption applies to extensions of credit by a depository institution to a nonaffiliate to enable the nonaffiliate to purchase securities through a registered broker-dealer affiliate of the institution that is acting exclusively as riskless principal in the securities transaction.

The second exemption exempts from the "attribution rule" extensions of credit by a bank to an unaffiliated customer who uses the proceeds to purchase securities from the inventory of a broker-dealer affiliate of the bank if the loan is made pursuant to a preexisting line of credit not entered into in contemplation of the purchase of securities from the affiliate.

The Board also released an interpretation that expands an insured depository institution's ability to purchase from an affiliated, registered broker-dealer securities that have a ready market and prices that can be verified from a reliable independent source. This exemption was first proposed in 1998, and the final exemption reflects the industry comments on the original proposal. For a securities purchase to be exempt from section 23A, several conditions must be met. Among other conditions, the security must (i) have a "ready market"; (ii) be eligible for a State member bank to purchase directly; (iii) not be a low-quality asset; (iv) not be purchased during an underwriting or within 30 days of an underwriting if an affiliate is an underwriter of the security, unless the security is an obligations of or fully guaranteed by the United States or its agencies; (v) have a price quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks; and (vi) not be issued by an affiliate (with certain exceptions). In addition, the price paid by the insured depository institution should be at or below the current market quotation for the security and the size of the transaction should not be so large as to cast material doubt on the appropriateness of relying on the current market quotation for the security.

The GLB Act also amended the Federal Reserve Act so that sections 23A and 23B would apply to transactions between a bank and its so-called financial subsidiaries.

Treatment of Financial Subsidiaries

With respect to a bank, the old definition of "affiliate" in sections 23A and 23B specifically did not apply to a company that is a subsidiary of the bank, with certain exceptions. This definition was consistent with the scope of activities of bank subsidiaries, which historically were permitted to engage only in activities that the parent bank could conduct. Today, some subsidiaries of banks engage in activities impermissible for the banks themselves and, with the passage of the GLB Act, financial subsidiaries have an even broader array of powers beyond permissible banking activities. Accordingly, the GLB Act also amended the Federal Reserve Act so that sections 23A and 23B would apply to transactions between a bank and its so-called financial subsidiaries.

Under the GLB Act and under proposed Regulation W, a financial subsidiary of a bank is considered an "affiliate" of the bank for purposes of sections 23A and 23B and, with certain limited exceptions, any covered transactions between a bank and its financial subsidiaries must comply with the same quantitative, collateral, and other restrictions imposed by sections 23A and 23B on other affiliates. The GLB Act also establishes other special rules for financial subsidiaries, which are described in more detail in the proposed Regulation W.

However, in passing the GLB Act, Congress recognized that banks need

to have some flexibility in conducting transactions with subsidiaries. Therefore, the GLB Act provided that the 10 percent restriction on covered transactions with any individual affiliate does not apply to transactions between a bank and any of its individual financial subsidiaries. However, the aggregate amount of the bank's covered transactions with all affiliates, including its transactions with its financial subsidiaries, would be subject to the aggregate 20 percent threshold.

Conclusion

This article only touches upon some of the many issues that are presented by proposed Regulation W and the related rulemaking for affiliate transactions. All of the rules were published in the Federal Register on May 11, 2001 and can be found on the Board's web site at <www.federalreserve.gov/regulations/regref.htm#w>.

It is likely that the final Regulation W will change from its proposed form as a result of the numerous comments received by the Board from the banking industry. Bankers and their advisors should be prepared to adjust to the requirements of Regulation W once it is issued in final form.

In the interim, depository institutions should direct any questions on the application of sections 23A and 23B and the final interim rules to their primary federal banking regulator. Institutions supervised by the Federal Reserve Bank of Philadelphia should direct questions to the examiner-in-charge of an ongoing supervisory event, the institution's central point of contact at the Reserve Bank, or an officer or manager in Community, Regional, and Global Supervision. ■

"Accounting for Goodwill"

continued from page 9

Disclosure Requirement

In addition to transitioning from expense recognition to fair value, one of the primary purposes of FAS 142 is to provide financial statement users with a clearer view of the investments made and the subsequent performance of the investments. Hence, financial statement users can expect to see more extensive financial statement presentation and disclosures related to goodwill and intangible assets, improving transparency and enhancing the utility of the financial statements.

Open Issues

As with any significant change in accounting procedure, many questions remain. For example, under FAS 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, financial institutions can recognize an unidentifiable intangible asset in the amount that the fair value of liabilities assumed exceeds the fair value of assets acquired. FASB specifically excluded these unidentified intangible assets when drafting FAS 142. However, FASB has agreed to conduct additional research on whether there are issues unique to business combinations of financial institutions that have an excess of the fair value of liabilities over assets that would require different guidance from that provided in FAS 141.

On May 13, 2002, FASB issued an Exposure Draft that would clarify that FAS 141 is the appropriate accounting guidance relating to the recognition of FAS 72 intangibles in a business combination involving stockholder-owned financial institutions. Comments are due to FASB by June 24, 2002.

In addition, some institutions have questioned whether capital guidelines would be adjusted to allow net-of-tax treatment of goodwill (i.e., total goodwill less the deferred tax liability). The federal regulatory agencies are considering this and other issues, and will issue formal guidance later in 2002.

Final Thoughts

While many acquirers in business combinations may appreciate the potential boost to earnings from the elimination of goodwill amortization, they face a challenge of the rigorous and complex valuation process. In order to comply with the provisions of FAS 142, companies will have to devote additional efforts in developing policies and procedures, providing additional training, and/or engaging outside expertise.

Questions on the application of FAS 141 and 142 for financial reporting purposes should be directed to the company's external auditor or other qualified individual. Institutions supervised by the Federal Reserve Bank of Philadelphia that have questions concerning the appropriate accounting and disclosure treatment for goodwill and other intangible assets for regulatory reporting purposes should contact Eddy Hsiao, Senior Examiner, (Eddy.Hsiao@phil.frb.org) at (215) 574-3772. ■

FEDERAL RESERVE BANK
OF PHILADELPHIA

The views expressed in this newsletter are those of the authors and are not necessarily those of this Reserve Bank or the Federal Reserve System.

Editor.....Cynthia L. Course

SRC Insights is published quarterly and is distributed to institutions supervised by the Federal Reserve Bank of Philadelphia. The current and prior issues of *SRC Insights* are available at the Federal Reserve Bank of Philadelphia's web site at www.phil.frb.org. Suggestions, comments, and requests for back issues are welcome in writing, by telephone ((215) 574-3760), or by e-mail (Cynthia.Course@phil.frb.org). Please address all correspondence to: Cynthia L. Course, Federal Reserve Bank of Philadelphia, SRC - 7th Floor, Ten Independence Mall, Philadelphia, PA 19106-1574.

E-Mail Notification Service

Would you like to read *SRC Insights* and *Compliance Corner* on our web site up to three weeks before they are mailed? Sign up for our e-mail notification service today!

Send an e-mail to Cynthia.Course@phil.frb.org to have your name added to the notification list.