

# Alert

May 2008

## Be Aware of Events Triggering Impairment

*“Issued concurrently with SFAS 141...FAS 142 represented a move towards Fair Value accounting.”*

In today's business environment with credit issues, consumer confidence issues, weakness in the dollar, etc., many companies are facing possible impairment issues. Given these circumstances, a review of SFAS No. 142, *Goodwill and Other Intangible Assets*, and the events which may trigger impairment, is in order.

### REVIEW OF SFAS 142

Issued concurrently with SFAS 141, *Business Combinations*, in 2001, SFAS 142 represented a move towards Fair Value accounting. This trend continued with the adoption of SFAS 157, *Fair Value Measurements*, in 2006. The following is a summary of the key points contained in SFAS 142:

- SFAS 142 defines a reporting unit as an operating segment or one level below an operating segment (referred to as a component). All goodwill for a company must be assigned or allocated to a defined reporting unit.
- Identifiable intangible assets either have determinable remaining useful lives (in which case they are amortized), or indefinite useful lives (in which case they are not amortized).
- Companies should evaluate the remaining useful lives of those identifiable intangible assets that are amortized each reporting period, and the remaining carrying amount should be amortized prospectively over the remaining useful life.
- Companies must test their goodwill for impairment annually against the implied fair value of the goodwill. The test is described in SFAS 142 as a two-step process:

**Step One:** The fair value of the reporting unit is compared to the carrying amount of that reporting unit, including its goodwill. If the carrying amount of the reporting unit exceeds its fair value, potential impairment is indicated and step two is performed.

**Step Two:** The implied fair value of the reporting unit's goodwill is determined by performing a hypothetical purchase price allocation, using the fair value of the reporting unit from Step One as the purchase price. If the carrying value of the goodwill exceeds the implied fair value of the goodwill, the carrying value of the goodwill is written down to its implied fair value. For companies selling a business that was part of a reporting unit containing goodwill, the goodwill associated with the business being sold should be determined based on the relative fair values of the business being sold and the portion of the reporting unit being retained.

- Companies are required to test indefinite-lived identifiable intangible assets for impairment against their fair value annually, or if events or changes in circumstances indicate that the asset might be impaired. More frequent impairment tests are appropriate when an event occurs “that would more likely than not reduce the fair value of a reporting unit below its carrying amount.”

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## Be Aware of Events Triggering Impairment

SFAS 142 refers to SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, for examples of such events:

- a) A significant decrease in the market price of a long-lived asset (asset group)
- b) A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition
- c) A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group) including an adverse action or assessment by a regulator
- d) An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived assets (asset group)
- e) A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)
- f) A current expectation that, *more likely than not*, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life

*“VRC has completed hundreds of valuations for SFAS 142 purposes.”*

### NEW GUIDANCE

The FASB recently issued a Staff Position (FSP) No. FAS 142-3, *“Determination of the Useful Life of Intangible Assets,”* which amends the factors a company should consider when developing renewal assumptions used to determine the useful life of an intangible asset under SFAS142. Paragraph 11 of SFAS 142 requires companies to consider whether renewal can be completed without substantial cost or material modification of the existing terms and conditions associated with the asset. FSP 142-3 replaces the previous useful life criteria with a new requirement - that an entity consider its own historical experience in renewing similar arrangements. If historical experience does not exist then the company would consider market participant assumptions regarding renewal including 1) highest and best use of the asset by a market participant, and 2) adjustments for other entity-specific factors included in para. 11 of SFAS 142.

Given the fact that SFAS 142 provided no clear guidance for determining what constitutes substantial cost or material modifications, the useful life of an intangible asset was often shorter than the period of cash flows used to value the asset under SFAS 141. In issuing FSP 142-3, the FASB hopes to improve the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset.

### EFFECTIVE DATE

The FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, as well as in interim periods within those fiscal years. Early adoption is prohibited. VRC has completed hundreds of valuations for SFAS 142 purposes. For more information contact your Valuation Research representative. **VR**

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