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ADVISER

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Writing Off Goodwill

A Weak Economy Makes Unscheduled Testing Necessary

In today's volatile economy, companies must pay close attention to goodwill impairment. Under current accounting rules, companies are required to test acquired goodwill for impairment annually. But unscheduled impairment tests may be necessary if certain triggering events — including a "significant adverse change … in the business climate" — have a negative impact on fair value. These days, most companies should be screening regularly for goodwill impairment, and, if necessary, recognizing impairment losses.

Interim testing

When a company acquires another company, the purchase price is allocated based on the fair values of the acquired assets. Any amount by which the purchase price exceeds the value of the target's identifiable net assets is treated as goodwill.

Under previous accounting rules, goodwill was treated as a "wasting asset," which meant it was amortized over its useful life, up to 40 years. In 2001, however, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, which provides that goodwill be tested annually for impairment (at the reporting unit level) and written down only if its carrying amount exceeds its fair value.

SFAS 142 also requires companies to test for impairment between annual tests if "an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount." Such triggering events include:

- A significant adverse change in legal factors or the business climate,
- An adverse regulatory action, Unanticipated competition,
- Loss of key personnel, or
- An anticipated (more likely than not) sale of a reporting unit or significant portion of a reporting unit.

In the current economic climate many — if not most — companies will find that a triggering event has likely occurred, requiring interim testing for impairment.

Two-step process

A triggering event doesn't automatically require your company to write off goodwill. It simply means there's a potential impairment that requires further investigation. Determining the existence of impairment is a two-step process. In step one, you determine the fair value of each reporting unit and compare that value to its carrying amount, including goodwill. If a unit's fair value exceeds its carrying amount, goodwill isn't considered impaired and step two isn't necessary.

(continued)

If, on the other hand, a unit's carrying amount is greater than its fair value, you must proceed to step two. There's a common misconception that the excess of a unit's carrying amount over its fair value is equal to the amount of goodwill impairment. But the fair value shortfall is merely an indication of possible impairment and you can confirm impairment only by following step two.

In step two, you compare the "implied fair value" of a unit's goodwill to its carrying amount. Performing this test is a complex process and typically requires the use of outside valuation expertise. It involves treating a unit's fair value as if it were the purchase price in a business combination. Then that value is allocated among the unit's assets and liabilities — including any intangible assets (other than goodwill).

If the unit's step one fair value exceeds the value allocated to these net assets under step two, the excess is the implied fair value of its goodwill. The excess, if any, of the carrying amount of goodwill over its implied fair value is the amount of the impairment loss that should be recognized.

A company potentially could go through step two and conclude that goodwill hasn't been impaired. This might happen, for example, when the fair values of certain tangible or identified intangible assets have declined. (For an example, see the sidebar "Hunting for goodwill".)

Value judgments

As the above suggests, fair value plays an important role both in accounting for business combinations and testing for goodwill impairment. You're probably aware that the rules for measuring fair value have been the subject of intense controversy in recent months. And valuing financial assets in illiquid and inactive markets is particularly challenging right now, despite recent FASB guidance on the subject.

Hunting for Goodwill

Just because step one of the SFAS 142 test indicates potential impairment doesn't necessarily mean that a company's goodwill is impaired. Suppose the step one analysis determines that a reporting unit's fair value is $10,000 and its carrying value is $12,000, including $3,000 in goodwill. Step one indicates a potential impairment of $2,000. It's necessary, therefore, to proceed to step two.

Step two's analysis determines that the fair value of the unit's net assets is only $7,000, making the implied fair value of goodwill $3,000 ($10,000 - $7,000). Because the implied fair value of goodwill is equal to its carrying value, goodwill hasn't been impaired. The company will need to apply other accounting rules to determine whether to record impairment on certain assets, such as long-lived assets.

So if you're planning a merger or acquisition, or testing for goodwill impairment, enlist the help of a qualified valuation professional who knows how to address fair value issues. The impact of SFAS 142 will depend to a great extent on the selection of reporting units and allocation of goodwill and other assets among them. You have some flexibility in making these allocations, and a CPA can facilitate the process. h

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Holtz Rubenstein Reminick LLP • www.hrrllp.com

1430 Broadway
New York, NY 10018
212-697-6900

125 Baylis Road
Melville, NY 11747
631-752-7400

To change contact information, please contact info@hrrllp.com

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