

## **Valuation Issues in Testing for Impairment Under SFAS 142**

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The Financial Accounting Standards Board (FASB) unanimously approved Statements of Financial Accounting Standards (SFAS) 141—Business Combinations and 142—Goodwill and Other Intangible Assets, in June. SFAS 142 places greater emphasis on asset valuation in the FASB's continuing evolution toward fair value reporting of assets and liabilities. The previous accounting treatment of goodwill as a consumable asset subject to annual amortization (representing consumption) over an estimated economic life of the asset was inconsistent with the progression towards a fair value balance sheet. SFAS 142 now requires the following accounting treatment for goodwill and other intangible assets:

- Identifiable intangible assets with finite lives will continue to be reported separate from goodwill and amortized over their remaining useful lives. Such assets should continue to be assessed for impairment pursuant to the guidance in SFAS 121.
- Goodwill and other intangible assets with indefinite lives will be assessed for impairment at least on an annual basis. This assessment should be performed at the "reporting unit" level (defined later).

Valuation and impairment testing under SFAS 142 is a two-step process. Step one involves determining the fair value of a reporting unit and comparing such value to the reporting unit's carrying value—defined as reported shareholders' equity including goodwill. If the fair value is less than the carrying value, an impairment analysis (step two) is required. A summary of the two-step process and various valuation issues to consider are as follows:

### **Valuation for Impairment—Step One**

The first step of goodwill impairment testing consists of comparing the fair value of the reporting unit to its carrying amount. However, before fair value can be determined, it is important to understand exactly what is being valued; namely, what is a reporting unit?

The reporting unit is defined as an "operating segment," or a component of an operating segment. An operating segment is defined by SFAS 131 as:

A component of an enterprise (a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise), (b) whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assets its performance, and (c) for which discrete financial information is available.

The valuation of a reporting unit is required if the assets composing such unit constitute a business and if the preceding requirements used in determining an operating segment are met. A reporting unit is considered an operating segment if it is economically similar and if no discrete financial information exists for such unit.

Another important consideration is to identify the appropriate standard of value. This determination should be made by a qualified business appraiser. The most common standard of value is *fair market value*. Business valuations for tax and other purposes are prepared using the fair market value standard. Fair market value is defined in the business appraisal profession as:

The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and both have reasonable knowledge of the relevant facts.

The standard of value required by Appendix F of SFAS 142 is *fair value* defined as:

The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Fair value defined by SFAS 142 is actually very similar to fair market value. The primary difference is that fair market value refers to a *hypothetical* willing buyer and willing seller and fair value relates to identifiable buyers and sellers. Accordingly, most valuation professionals agree that SFAS 142 fair value could be described as an “investment value” to the current owners. Therefore, internal synergies created by a company may be considered in the computation of fair value—whereas synergies are usually not considered in the determination of fair market value.

Once the standard of value has been determined, a valuation of the reporting unit is prepared using the segmented financial information available for such unit. No further testing is required if the fair value of the reporting unit exceeds its carrying amount. If the carrying amount of the reporting unit exceeds its fair value, then step two is required. The second step consists of determining the fair value of all identifiable assets and liabilities in order to determine the implied fair value of goodwill.

### **Valuation for Impairment—Step Two**

The FASB has indicated that goodwill cannot be measured directly, but instead is computed as a residual amount of the excess of the fair value of the reporting unit over and above the fair value of all the unit’s identifiable assets (tangible and intangible) and liabilities. Accordingly, step two consists of determining the fair value of each asset and liability of the reporting unit. This step may require obtaining appraisals of fixed assets such as real estate and machinery and equipment.

It is important for business appraisers to work with the company and their auditors during step two to ensure that all intangible assets subject to fair value determination are identified. The provisions of SFAS 142 apply to intangible assets acquired either individually, in a group with other assets comprising less than a business, or in a business combination. An intangible asset should be recognized separately from goodwill when the following conditions are satisfied:

- The asset arises from contractual or other legal rights
- The asset is separable (i.e. it can be sold, transferred, licensed, rented or exchanged)

It is important to note that the separability element of the asset requires separate recognition of the intangible asset whether or not the contractual or other legal rights test is met. Appendix A of SFAS 141 provides five distinct categories, with examples of specific types of intangible assets, that meet the criteria for recognition separately from goodwill:

- **Marketing-related** (i.e., trademarks and internet domain names)
- **Customer-related** (i.e., customer lists, order backlogs)
- **Artistic-related** (i.e., literary and musical works)
- **Contract-based** (i.e., licensing, lease and franchise agreements)
- **Technology-based** (i.e., computer software and other patented or unpatented technology)

The fair value of goodwill is calculated as the difference in the fair value of the reporting unit less the fair value of each identifiable tangible and intangible asset of such unit. Impairment of goodwill and/or other intangible assets with indefinite lives has occurred when the fair value of such assets is less than their carrying amount. Accordingly, an adjustment is required to decrease the carrying amount of goodwill and/or indefinite-life intangible assets to fair value. Such impairment loss will be reflected on the income statement in income from continuing operations. However, impairment losses arising from initial application of SFAS 142 may be recorded as a change in accounting principle.

SFAS 142 raises several new and challenging valuation questions, many of which could not be addressed in this brief article. It is important for company management and their auditors to work with an experienced valuation professional who has a thorough knowledge of business valuation, intangible asset valuation and purchase price allocation. Furthermore, in the wake of the current financial reporting crisis, it is now more important than ever to ensure that the valuation component of SFAS 142 is completed using an independent, competent valuation expert.

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