Asset Impairment: Transitioning under FAS 142

By René Hlousek
San Francisco Office

Foreword

The date is February 2002. As Paul Eagan signs the $200,000 check, he asks himself: "Was this all really worth it?" This is a question that Paul, a chief financial officer at Zentech Corporation ("Zentech"), a telecommunications firm based on the west coast, may ask himself as the ink dries. For the past two months, Zentech has been working closely with an independent valuation firm to determine the valuation drivers behind the company's wireless communications division, a subsidiary formed through an acquisition in August 2000 (the "Transaction"). The company's finance department has been quite busy. Since July 2001, Zentech's management has been examining its intangible assets closer than ever before. That is because the Financial Accounting Standards Board ("FASB" or the "Board") had just issued Statement 142: Goodwill and Other Intangible Assets, which requires all companies with previously recognized goodwill to test that goodwill for impairment as of the beginning of the fiscal year in which FAS 142 is initially applied in its entirety. In addition, the company must prepare for mandatory goodwill impairment tests required to be completed on an annual basis thereafter. The purpose of this article is to discuss the potential impact of FASB's recently issued Statement 142 on a corporation's decision-making process during the transitional phase following its adoption of the Statement. The names and dates utilized in this case study are hypothetical in nature and merely facilitate the story behind the latest issues surrounding FAS 142 and the Statement's impact on our view of intangible assets within the dynamic mergers and acquisitions environment of today. This is the second article of a four part series that will examine intangible assets and their treatment in acquisitions and corporate liquidations.

Genesis of New Framework from FAS-121

FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, was issued in March 1995. After Statement 121 was issued, members of the Emerging Issues Task Force ("EITF") and others identified significant questions relating to its implementation. The Board added a project related to Statement 121 to its agenda in August 1996. The project's objectives were to (a) address significant implementation questions and (b) develop a single accounting model based on the framework established in Statement 121 for the disposal of long-lived assets, whether previously held and used or newly acquired. The Board issued an Exposure Draft of a proposed Statement, Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities, in July 2000. The proposed Statement supersedes Statement 121.

The effects on financial statements of FAS 121 were three-fold. First, the income statement was affected by the amount of the impairment loss. Second, the balance sheet was affected in that net equity is decreased by the amount of the impairment through revaluation of the asset and the charge to retained earnings from the income statement. In future periods it was expected that stated asset values would more closely resemble actual market values, and earnings would normally increase as a result of decreases in depreciation expense. Third, impairment losses were expected to decrease in size (fewer "big baths"), but be reported more frequently, resulting in timely information.

FAS 121 required the use of both undiscounted future cash flows and fair values to recognize and measure impairment. Paragraph five of FAS 121 lists several impairment indicators, such as operating losses, significant adverse changes in the legal and economic climate and changes in the manner in which an asset is used. When one or more of these triggering events were present, an entity had to estimate the net future cash flows (undiscounted and without interest charges) associated with the use of that asset and its eventual disposition. When estimating cash flows, assets were grouped at the lowest level at which cash flows were identifiable and independent from other groups. If these cash flows were less than the carrying amount of the assets, the entity had to recognize an impairment loss. Under FAS 121, gains or losses on impairments of assets were reported in the income statement as ordinary income before income taxes, preferably under a separate caption. In addition, footnotes had to include a description of the impaired assets; the business segments in which the assets were located; the facts and circumstances leading to impairment; the expected disposal date, if applicable; and the carrying amount of these assets.

Prior to the issuance of FAS 142, certain triggering events had to occur before an impairment test was performed, as was mandated under FAS 121, which usually meant that an impairment test was never needed if the underlying transaction was profitable to the acquirer. Under FAS 142, this is no longer the case. Instead, intangible assets will be tested for impairment annually and on an interim basis if an event or circumstance occurs between annual tests that might reduce the fair value of that asset. This is where Paul Eagan's frustration comes in. Zentech's wireless communications division has been profitable, despite the volatilities in the high-tech sector. There has been no triggering event that would have suggested an impairment of Zentech's assets. However, to ensure Zentech's compliance with future annual impairment tests, as mandated by FAS 142, Zentech has to assist an independent valuation firm in determining the appropriate valuation methodologies and assumptions to be used on all future annual impairment tests. The Board believes that in preparing for the annual testing, it is necessary to ensure that an entity has identified and documented all key assumptions and tested the outputs of the selected valuation model for reasonableness prior to testing goodwill for impairment.

Proposed Benchmark Assessment Requirement Not Needed

The 2001 Exposure Draft proposed that a benchmark assessment be performed in conjunction with the most significant acquisitions and in connection with a reorganization of an entity's reporting structure. As proposed, a benchmark assessment involved identifying and documenting the goodwill and net assets associated with a reporting unit, the expectations related to the performance of the unit, and the valuation model and key assumptions to be used in measuring the fair value of the reporting unit. In addition, an entity would have been required to measure the fair value of the unit, compare the fair value with the carrying amount, and possibly test goodwill for impairment. The purpose of the benchmark assessment test was to establish a starting point for future goodwill impairment tests.

The Board concluded that a requirement to perform a benchmark assessment was no longer necessary because goodwill would be tested for impairment annually and because the first step of the impairment test would be a comparison of the fair value of a reporting unit with its carrying amount. Board members observed that most of the identification and documentation steps inherent in the benchmark assessment would have to be performed subsequent to an acquisition or reorganization and prior to any impairment test regardless of whether FAS 142 required performance of those steps. However, FAS 142 does not require that the groundwork for performing an impairment test be completed within a set time period other than that necessary to perform the transitional goodwill impairment test.

The Asset Impairment Controversy

All entities, regardless of size, are subject to the risks and uncertainties of economic and technological change. Rapid technological advances, intense domestic and global competition, volatile interest and foreign exchange rates, and rapid changes in market demand can create obsolescence of plant, machines, and intellectual property and can cause assets to lose some or all of their capacity to recover their costs. Poor management decisions on resource allocations can also impair the value of assets. One view of write-offs of asset impairments is that management uses the accounting rules and manipulates earnings either by not recognizing impairment when it has occurred or by recognizing it only when it is advantageous to do so. An alternative point of view is that managers take write-offs not to manipulate earnings, but to reflect declines in the values of assets due to poor firm performance and poor management decisions.

The old FAS 121 has accomplished much in giving direction and establishing a framework for impairment accounting. However, two controversies that were instrumental in allowing management manipulation of write-offs and causing diversity in practice still remain and have not been addressed under FAS 142. First, during the preparation for the annual impairment tests required by FAS 142, management may want to develop a model that tends to overestimate future cash flows to avoid write-offs. At other times, management may believe a significant write-off will benefit the company in the long-term. In these instances, they may develop a model that underestimates cash flows. Second, unrealized gains of some assets could offset unrealized losses of others, resulting in no required write-off. Consequently, management may tend to group assets inappropriately at times to avoid asset impairment write-offs.

Managing Asset Impairment under FAS 142

Can FAS 142 force management to recognize, in a timely manner, asset impairments? Past controversies may be examined to assess the probable impact of FAS 142 on their settlement. Similar to FAS 121, the recognition criteria under FAS 142 allow management to use much judgment. Most managers use both external criteria and internal calculations and determinations, such as net cash flow projections for an asset or group of assets, to assess whether an asset impairment has occurred when the usual triggering signs are not present. Thus, management should implement policies and procedures to identify possible impairment indicators based on a company's operating environment.

Companies may want to assemble an internal task force responsible for measuring and frequently evaluating asset values, useful lives, salvage values, and depreciation or amortization amounts. It seems that FAS 142 could ultimately force management to follow the process of annual or quarterly evaluation of these metrics because it will become more cost effective and routine to do so, substantially eliminating the need for periodic write-offs. The ever increasing pace of change in our economy and technology is gradually reducing the useful lives of all intangible assets, lending credibility to this assumption. Under FAS 142, because Zentech is expected to prepare for the annual impairment test process, Paul should consider and document the following:

- Key expectations related to future performance of the reporting unit;
- Model and key assumptions to be used in measuring fair value (e.g. description of cash flow model, interest rate assumptions);
- Methods and key assumptions to be used to measure assets and liabilities;
- Measurement of the fair value of the reporting unit;

- At inception, reassessment of goodwill assigned to reporting unit based on the above;

- Methodology must be applied consistently at future impairment reviews.

Given the current state of the economy and financial markets, financial firms are urging their clients to disclose more information to the market to accurately assess company values. The accounting community asserts that current standards of corporate financials fail to account for intangible assets and non-financial drivers such as speed to market; competitive landscape, and the quality and experience of the management team. Outdated corporate reporting poses a direct and serious threat to capital markets and urges a dramatically different reporting framework. On one hand, the market doesn't think it's getting good information from companies. On the other hand, companies' management says internal systems don't exist to gather adequate information to disseminate in the market. Accounting for all intangible assets would bring the benefits, over time, of increased share values, a lower cost of capital, access to new sources of capital, increased credibility for company management, more long-term investors, and a greater following from analysts. By closely examining, on an ongoing or regular basis as mandated by FAS 142, the value drivers behind and the financial condition of the intangible assets purchased by Zentech during the August 2000 acquisition, Paul will be providing the investment community with a more complete set of tools necessary to follow the progress of Zentech's past and future investments and make more informed decisions about subsequent investments in the company, if desired.

The Immediate Impact of FAS 142 on the Corporation

According to FAS 142, intangibles in each reporting unit should be tested for impairment as of the beginning of the fiscal year in which this Statement is applied initially in its entirety. The transitional asset impairment test should be performed as of the beginning of the year of initial application (adoption) and the first step of the impairment test should be completed within six months of adoption. By fully adopting the Statement at the beginning of year 2002 and completing the preparation phase related to the assets of its wireless communications division in February 2002, Zentech has positioned itself to be able to perform the first step of the annual impairment test within the next four months, placing it well within the requirements of FAS 142. Once the first step of the initial impairment test is performed, if the carrying amount of the net assets of a reporting unit (including goodwill) exceeds the fair value of that reporting unit, the second step of the impairment test must be completed as soon as possible, but no later than the end of the year of adoption.

If events or changes in circumstances indicate that goodwill of a reporting unit might be impaired before completion of the transitional goodwill impairment test, goodwill should be tested for impairment when the impairment indicator arises. Although Zentech's wireless communication's division has not exhibited any events that would indicate a potential asset impairment during the course of its transitional impairment test, the management should continually test the values of the intangibles of the unit to avoid surprises during the upcoming mandatory annual impairment tests. During the company's preparation for future impairment testing, Paul and his team should also be aware of the impact an impairment loss, if found through the annual testing, would have on the company's financials. A company must also recognize that the accounting treatment and reporting of an impairment loss depends on the implementation phase during which the testing of the impairment was performed and the loss identified (transitional impairment or annual impairment testing phase). The following chart depicts the process behind the determination of an impairment loss and its impact on the financial statements of the company:

Step 1: Initial Impairment Test

($000's)

	Year 1	Year 2	Year 3	Year 4	Year 5
Cash Flow:	12,500	14,000	11,000	7,000	3,000
Sum of Cash Flows (undiscounted):	47,500				
Carrying Amount of Asset:	60,000				

Conclusion: Asset Impairment Present - Step 2 Required

Step 2: Determination of Amount of Impairment

Carrying Amount of Asset:	60,000
Less: FMV of Asset (based on DCF model):	35,000
Amount of Asset Impairment:	25,000

Step 3: Financial Statement Adjustments

Income Statement		Balance Sheet	
Original Operating Income:	16,000	Carrying Amount of Asset:	60,000
Less: Asset Impairment:	25,000	Less: Asset Impairment:	25,000
Loss from Operations:	(9,000)	New Carrying Amount of Asset:	35,000

Transitional Disclosures

As mandated by FAS 142, upon completion of the first step of the transitional impairment test, the reporting segment in which an impairment loss might have to be recognized and the period in which that potential loss will be measured should be disclosed in any interim period financial information. In the period of adoption and thereafter until all periods presented are accounted for in accordance with the Statement, the following information should be displayed either on the face of the income statement or in the notes to the financial statements: income before extraordinary items and net income for all periods presented adjusted to exclude amortization expense recognized in those periods related to goodwill, intangible assets that will no longer be amortized, any deferred credit related to an excess over cost, and equity method goodwill. The adjusted income before extraordinary item and net income also should reflect any adjustment for changes in amortization periods for intangible assets that will continue to be amortized. In addition, the notes to the financial statements should disclose a reconciliation of reported net income to the adjusted net income. Similarly, adjusted earnings per share amounts for all periods presented may be presented either on the face of the income statement or in the notes to the financial statements.

Concluding Comments

Any attempt to fix a well-grounded and precise value for an intangible asset can be daunting. Nonetheless, the techniques for measuring the fruit of the unobservable asset are unique in each circumstance. A widening consensus is growing that the importance of such assets, from brand names and customer lists to technology and patents, means that investors need to know more about them. A task force appointed by the Securities and Exchange Commission in early 2000 has been urging the S.E.C. to find a way to encourage companies to provide more information regarding those assets, but will stop well short of demanding that companies be required to make more disclosures. With the introduction of FAS 142, the investment community will see just that – more disclosure.

Under FAS 142, companies will have to disclose both intangible assets and various quantitative measures that can shed light on how companies in some industries are performing, or under performing. One of the primary reasons that FAS 142 was issued by FASB was to increase the consistency and comparability of financial statement information among entities. The FAS 142 requirements for intangible asset valuation, for example, make it clear that management must evaluate asset values quarterly or annually, as appropriate. Another benefit should be an increase in consistency and comparability due to the uniformity that FAS 142 brings to the calculation of the impairment of intangible assets, through the implementation of the transitional impairment test requirement. However, some inconsistencies may still remain due to the amount of subjective estimates and judgment involved in applying the Standard, but they should be occurring in a greatly reduced rate when compared to the situation before its issuance. Despite the amount of "room" left in the Standard that may allow management to manipulate the figures, FAS 142 will provide investors with better insight into management policies and actions. Although perceived as costly and time consuming by some corporations, FAS 142, if implemented correctly, should benefit corporations and their shareholders alike.