

Implementing the Guidelines: FASB Statement 142

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FASB 142 Overview

In July 2001, the Financial Accounting Standards Board (FASB) formally issued new standards on the treatment of Goodwill and other intangible assets in Statement 142, *Goodwill and Other Intangible Assets*. With limited exceptions, Statement 142 applies to fiscal years beginning after December 15, 2001.

According to FASB Statement 142, companies may no longer amortize Goodwill annually. Instead, Goodwill must be tested for impairment at the reporting unit level on an annual basis. The Statement defines impairment simply as the extent to which the Carrying Amount of Goodwill or an intangible asset exceeds its Fair Value (“Value”). Additionally, companies must perform a similar and separate analysis on any other intangible assets carried on its books.

Big Deal or Bad Deal?

The potential ramifications of this change in accounting methodology are extensive. Where no impairment is found to exist, we can expect reported net income to increase by the amount that would have previously been charged to amortization expense. This change would appear, at least superficially, to benefit the reporting company. Publicly traded stocks suddenly appear cheaper based on price to earnings ratios (“PE ratio”). Indeed, PE ratios may decrease by more than 5%.¹

The news, however, is not all bright. In situations where companies sustain significant impairment of Goodwill or other major intangible assets, Statement 142 requires all of the

impairment to be recognized in a single reporting year as a charge against income. An exception to this requirement has been conceded by FASB that allows the initial, or transitional, year's impairment loss to be described in filings as the "effect of a change in accounting principle." After this transitional year, the loss will directly affect a company's bottom line.

As recent headlines shout, the effect can be gargantuan. JDS Uniphase's \$39.8 billion impairment loss seemed large until we read AOL Time Warner's recent announcement of a one-time \$54 billion write-down of Goodwill as a result of the accounting change. We expect many smaller companies to recognize proportionally similar impairment losses.

Because Goodwill frequently constitutes a company's single largest asset, a write-down of Goodwill can materially alter the capital structure of the business. Particularly in the case of a hypothetical small high-tech startup, this impact could prove disastrous. It is not uncommon for a company's debt or preferred stock covenants to stipulate a minimum threshold debt-to-asset ratio or some other financial metric that is materially altered by the implementation of FASB 142. Impairment write-downs could place such a company in technical default. The following table illustrates such a situation:

Start Up, Inc.
Balance Sheet as of December 31, 2001
(\$ millions)

<i>Non-current Assets</i>	
Plant and equipment	\$ 100.0
Goodwill	<u>1,000.0</u>
Total non-current assets	\$ 1,100.0
<i>Long-term Liabilities</i>	
Senior Notes due 2006	\$ 500.0

In the case of Start Up, covenants associated with the Senior Notes due in 2006 stipulate that the company maintain asset to debt coverage of at least 1.5x. Before any Goodwill write-down, the ratio stands at 2.2x, as illustrated. Upon implementing a FASB 142 review, the company discovers impairment of Goodwill associated with acquisitions made at the height of the tech boom necessitating a write-down of \$700 million. The adjusted balance sheet looks very different:

<i>Non-current Assets</i>		
Plant and equipment		\$ 100.0
Goodwill		1,000.0
Less write-down (<i>FASB 142</i>)		<u>(700.0)</u>
Total non-current assets		\$ 400.0
 <i>Long-term Liabilities</i>		
Senior Notes due 2006		\$ 500.0

The resulting debt coverage ratio has plummeted to 0.8x, well below the threshold stipulated in the debt covenants. The accounting rule change has placed Start Up in technical default, an event that would not have occurred under previous accounting rules.

A Cumbersome Chore

Not only can FASB 142 significantly impact earnings, the cost and effort of implementation can be considerable as well. Given the definition of “reporting unit,” some large companies may be required to test for impairment in scores of markets. Sensitive to the testing burden associated with the accounting change, FASB has ruled that, going forward, companies may presume that the current Fair Value of a unit exceeds its Carrying Amount (i.e., *that no*

impairment is present) if the following criteria have been met within the prior year: (1) the unit's assets and liabilities have not changed significantly; (2) the previous computation of the reporting unit's Fair Value exceeded the Carrying Amount by a substantial margin; and (3) no adverse events have occurred. Under these circumstances, the presumption may obviate the need for impairment testing. This clause appears to be of greatest benefit to companies that have performed rigorous impairment testing at least once to set a benchmark for future analysis.

By contrast, the Goodwill of a reporting unit must be tested for impairment *between* annual tests in the following instances: (1) an event occurs that would likely reduce the Value of a reporting unit below its Carrying Amount; (2) an expectation arises that a reporting unit will be sold or disposed; or (3) the Value of a significant asset group within a reporting unit is questioned. This provision would seem to place an undue burden on companies actively selling or exchanging properties to value assets more often than once annually.

Implementation: What To Do, How To Do It

The test used to measure the impairment of Goodwill consists of two parts. First, the Value of a reporting unit is compared to its Carrying Amount. If the Value of the reporting unit is greater than its Carrying Amount, the guidelines require no further analysis. If, however, the Carrying Amount is found to be greater than the Value of the reporting unit, the rules mandate a second step to quantify the implied Value of Goodwill and, consequently, the amount of impairment that must be recognized and written off. The implied Value of Goodwill is determined by establishing the Value of all other assets of the reporting unit and comparing this amount to the reporting unit's Value. The difference between the sum of the identified assets

and the reporting unit's Value is the implied Value of Goodwill. If the Carrying Amount of Goodwill exceeds its implied Value, an impairment loss must be recognized equal to the excess.

In practical terms, the identification of "all other assets" is literal. Even assets that had not been previously identified or booked must be isolated and valued to determine the aggregate Value of all tangible and intangible assets other than Goodwill in a manner similar to a purchase price allocation.

A Special Case for Media Companies?

For many radio and television broadcasters, testing for Goodwill impairment may be obviated by the absence of significant Goodwill on broadcasters' books. Based on the nature of television viewing, radio listening, and advertiser spending, courts have frequently concluded that media concerns do not possess the traditional manifestations of true Goodwill. Generally, no audience or advertiser loyalty to stations themselves exists. Viewers and listeners select a particular station based on station programs and personalities, without preference for the station itself. Many broadcasters carry limited Goodwill on their books.²

Other Intangible Assets

Separate from the analysis to determine potential impairment of Goodwill, FASB 142 requires that companies review intangible assets with and without determinable lives for impairment on an annual basis.

In contrast to the second step of Goodwill impairment testing, only intangibles that have been recognized previously and reported in financial statements need be analyzed. Companies

may not book “new,” or previously unrecognized intangible assets as part of this process, even if they were identified during the Goodwill impairment analysis.

Key Dates

The provisions of the FASB 142 Statement are to be implemented beginning with fiscal years starting after December 15, 2001. Companies with fiscal years beginning after March 15, 2001 may choose early adoption.

Goodwill testing is to be performed on an annual basis (and more frequently when circumstances indicate likely impairment). This annual testing may be performed at any time during the year, but must be conducted at the same time every year.

Perhaps the single most important timing element of the ruling regards the presentation of losses recognized during the first year of implementation. Impairment losses stemming from the write-down of Goodwill and indefinite-lived intangible assets recognized during the initial implementation of the rule are to be reported as resulting from *a change in accounting principle*. All subsequent write-downs will directly impact net income. For many companies, therefore, it will be prudent to take any painful hit during the first year. Moreover, the general downturn in corporate earnings during 2001, as well as the extraordinary impairment losses already reported by certain companies, may provide some shelter from harsher analyst scrutiny.

Valuation Methods and Necessary Materials

FASB 142 provides for a number of acceptable methods for determining the fair market value of reporting units and assets being tested for possible impairment. These methods include an income approach employing discounted cash flow projections; comparing recent sales of

comparable assets; the application of industry standard multiples for revenue or cash flow; or, indeed, virtually any method generally recognized as appropriate in an industry. In some cases, one of these methods may be employed as the primary valuation approach with validation by other methods.

Interestingly, FASB 142 bars a company's audit firm from performing the new impairment testing procedures. In light of recent headlines, this stricture may represent FASB's proactive attempt to separate consulting functions from the audit practice. While the ruling does permit a company to conduct the required analysis itself, many companies are turning to independent valuation firms with specific industry focuses or to other Big 5 firms to perform the testing. Because the firms will not necessarily have access to the subject company's internal data, it will be incumbent on the company to provide detailed financial and operational information in order to determine Carrying Values, and to construct discounted cash flow models and other tools for the valuation of Goodwill and other intangible assets. Financial data must be provided broken out by reporting unit as well as consolidated at the corporate or regional level.

The FASB 142 review process represents a major step toward enhancing the transparency of the accounting for Goodwill and other intangible assets, and to provide investors a clearer picture of a company's financial health and value. When significant intangible assets decline in value, the new standard will provide a much more accurate picture of a company's asset value. The principle of conservatism prohibits the upward adjustment of Goodwill and other intangible assets, honoring the accounting adage, "*anticipate no gains, but provide for all probable losses.*" Timing, as ever, remains critical. Early recognition of losses under the *change of accounting rule* banner will prove much less onerous than postponing an inevitable future write-down.

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Endnotes

¹ Using data taking into consideration the impact of FASB 142, Prudential estimated the S&P 500 12-month forward PE at 21.3x, a decrease of about 1.2x from their earlier estimate of 22.5x, using the prior accounting standard. This represents a decline of approximately 5.3%. *Source:* Prudential Financial, *The Valuation and Earnings Trends Report*, January 24, 2002.

² This treatment of Goodwill is consistent with court decisions holding that radio and television stations have no Goodwill. KFOX, Inc. v. United States, 510 F.2d 1365, 1377 (Ct. Cl. 1975), citing Roy H. Park Broadcasting, Inc. v. Commissioner, 56 T.C. 784, 813 (1971); Meredith Broadcasting Co. v. United States, 405 F.2d 1214, 1216 (Ct. Cl. 1968). In KFOX, Inc., the Court of Claims found that a radio station did not have any particular Goodwill in the sense of listener preference or loyalty to the station because radio audiences are attracted primarily by an individual personality or format, and not by a particular broadcast station. 510 F.2d at 1377. The court in Roy H. Park Broadcasting, 56 T.C. at 813, succinctly stated this position:

... we agree that there is little, if any, Goodwill between station audience since, as has been demonstrated, viewers are concerned with the quality of programs rather than with the particular call letters or management of a station ...

Similarly, in Meredith Broadcasting, the Court of Claims found that a television station did not have any particular Goodwill in the sense of viewer preferences or loyalty to the station because television audiences are attracted primarily by the programs and not by the particular broadcast station, call letters, station personnel, or management. 405 F.2d at 1216.