



A New Era of Accounting Standards

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AMORTIZE:

- ◆ To liquidate or extinguish a mortgage, debt or other obligation, especially by periodic payments to the creditor or to a sinking fund.

GOODWILL:

- ◆ An intangible, salable asset arising from the reputation of a business and its relations with its customers.

By reading these definitions of amortize and goodwill, as provided by The Random House Dictionary, one might conclude that goodwill should increase as a company grows, rather than diminish at some arbitrary rate. However, over thirty years ago, the Accounting Principles Board (APB)¹ issued Opinion No. 17 (APB 17), requiring goodwill resulting from an acquisition where purchase method accounting was applied to be amortized systematically over a finite life. Ever since then, many analysts and investors have been arguing against this unfounded practice of reducing a company's earnings.

The Financial Accounting Standards Board (FASB)² recently overturned APB 17 with Statement of Financial Accounting Standards No. 142 (FAS 142) - Goodwill and Other Intangible Assets. Pursuant to FAS 142, goodwill amortization has been eliminated for financial reporting purposes. Instead, all newly acquired and existing goodwill is to be tested annually³ at each reporting unit to determine whether it has been impaired, applying a 2-step test:

STEP 1: Conduct "Screening Test" - compare reporting unit's Fair Value (FV) to its Carrying Value (CV):

- i) The FV of reporting unit is defined by FASB as "the amount at which an asset (or liability) could be bought (or incurred) or sold

¹ THE APB WAS THE STANDARDS-SETTING BODY FOR ACCOUNTING PRINCIPLES THAT ISSUED OPINIONS FROM NOVEMBER 1962 TO JUNE 1973. IT WAS SUCCEEDED BY THE FASB.

² THE FASB IS A PRIVATE SECTOR ORGANIZATION DESIGNATED TO ESTABLISH STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING. FASB'S STANDARDS ARE RECOGNIZED BY THE SEC AND THE AICPA AS GOVERNING THE PREPARATION OF FINANCIAL REPORTS.

³ CERTAIN CIRCUMSTANCES THAT INDICATE IMPAIRMENT MAY REQUIRE MID-YEAR TESTING.



(or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."

- ii) The CV of reporting unit is the total asset reported on its balance sheet.

If FV > CV, no further actions are taken

Step 2: If FV < CV, proceed with detailed analysis to determine goodwill impairment:

- i) Determine FV of reporting unit's net assets.
- ii) Deduct FV of reporting unit's tangible and intangible net assets to determine implied FV of goodwill.
- iii) Deduct implied FV of goodwill from CV of goodwill to determine impairment charge, if negative.

What does this mean for companies carrying goodwill on their balance sheets? While they may incur additional upfront costs to have an independent provider of business valuations conduct the annual goodwill impairment test, their earnings will reflect a more accurate snapshot of their operations.

Who is qualified to perform goodwill impairment testing? The SEC recently issued revised auditor independence rules stating that a company's accountant cannot provide independent valuation and audit opinions if it is reasonably likely that the results of the valuation would be material to the financial statements, or where the accountant would audit the results.

SP&H is a premier, independent provider of business valuations, with an emphasis on valuing intangible assets and goodwill. SP&H's sole business is providing comprehensive business valuations, due diligence and articulate reporting that can withstand third-party scrutiny.

For more information about determining goodwill impairment or valuing intangible assets, please contact SP&H at (310) 571-3400 or bizval@sphvalue.com.