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SFAS 144 Considerations

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Perspective on SFAS 144 Testing

- Increased use in a down economy
  - Last period of heavy focus was 2001/2002 time period
    - Post dot.com bubble, September 11
- In recent years you may have not been asked to do this test
  - Often if no goodwill impairment is found per SFAS 142 then a SFAS 144 test is not performed
  - The concept is that goodwill is the first intangible to be impaired, as it is the most speculative with an easier impairment test to fail (vs. SFAS 144)
- Also, in some cases you may performed a SFAS 144 in recent years, but little focus may have been placed in the review process on this analysis
  - Now more emphasis is being placed on the fundamentals and in some cases is leading to a change in methodologies from previous years

Asset Specific Testing vs. Grouped Testing

- SFAS 144 discusses performing the analysis for groups of assets vs. the specific intangible asset
- While the "door is left open" to do the analysis on an asset specific level, most likely some sort of grouped analysis should be performed
- This may be counterintuitive but is often the required methodology
  – Hard for many to grasp why best method would not be doing an undiscounted version of the analysis done for the purchase price allocation
- As already discussed, the groupings should be determined by management in consultation with the auditors
- Remember: Asset groups considered are only long lived assets that can be depreciated or amortized

Asset Specific vs. Grouped Testing (cont.)

- Would be inappropriate to assume an asset-specific analysis could be performed without thorough consideration of all relevant factors and discussions with the auditors
- Remember that asset groups include tangible and intangible assets
- Groups are more likely to be characterized by operations vs. types of intangibles
  - For example, two different plants selling different products to different customers would likely require multiple asset groups
  - If there is one plant with one product line and one group of customers only one asset grouping might be needed

Valuation Considerations - Revenues

- Often different for a grouped analysis versus an asset-specific analysis
- For example, even if customers are the primary asset in the group, one can consider revenues from new customers that might be obtained through other assets in the group
- Therefore, a revenue analysis like would be done for customers in a purchase price allocation analysis (that includes attrition) would likely not be appropriate

Valuation Considerations – Expenses

- Only include expenses necessary to support level of revenues projected
- Certain expenses might not be needed to support the estimated revenues, particularly as you get near the end of the projection period
  - For example, in the last year of the projections, make sure to exclude any sales and marketing expenses devoted to generating revenues in subsequent years
- Capital expenditure requirements would also likely taper off as you get near the end of the projection period

Valuation Considerations – Asset Charges

- May have other assets outside of the group that contribute to the projected cash flow streams (e.g. trademark with an indefinite life)
  - While there may be some diversity in practice, it is argued here that a contributory asset charge should be applied for the contribution of the other asset(s) to the projected cash flow streams
  - Calculation would be similar to that performed for a purchase price allocation analysis
  - Projections should reflect necessary contributions of capital expenditures and working capital as well

Other Considerations for Analysis

- Pretax or not pretax? (personal viewpoint is after tax more appropriate)
- If after tax, consideration should be given to a tax amortization/depreciation benefit and that this benefit would be on an undiscounted basis
- Should contributory asset charges be applied and how? (personal viewpoint is should be applied if not part of the group being analyzed and contribute to the projected cash flow streams)

Fair Value Considerations

- For step two analyses (and step one impairment analyses per SFAS 142), current market conditions have made estimating fair value challenging
- For example, risk free rates are significantly lower, and in some cases companies are significantly more leveraged
- Further, in many cases betas are lower
- Therefore, if one did a standard discount rate calculation, a significantly lower discount rate could be calculated.
- Does this make sense?

Fair Value Considerations (cont.)

- The answer is no
  - Risk free rates are lower due to a flight to quality for low-risk investments
  - Betas are lower because market volatility is skewed from the performance of financial stocks
  - Being more leveraged is not a good indication from a risk standpoint, and equity rates typically increase with higher leverage
  - Lower market pricing and higher volatility indicate greater risk
  - Indications that equity rates should be higher are that debt rates are significantly higher, implied equity risk premiums are higher, and the spreads between risk free investments and higher-yield investments are significantly higher
- Therefore, all other things being equal, one would expect a higher discount rate now vs. a year ago

Final Thoughts

- SFAS 144 impairment testing can be challenging
- Therefore, it is very important to speak with management and auditors in the beginning of the process to determine what needs to be tested (and in what groups)
- Diversity in practice exists, so be prepared for possible differences of opinion (advance conversations mitigate this issue)
- When the economy improves, this issues will be focused on less
- The recent recommendations by the SEC in their mark-to-market study may lead to streamlined impairment testing and lead to this rule being less problematic