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February 2009
Vol. 2009-04

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VALUATION observations

Goodwill Hunting: Improper Purchase Price Allocations Lead to Large Write-Downs

By Brian D. Bornino and Kelly N. Curtin

Many companies have improperly accounted for business acquisitions by recording the difference between the purchase price and the fair values of tangible assets simply as "goodwill", rather than recording the fair values of acquired intangible assets, as required by Statement of Financial Accounting Standards No. 141, *Business Combinations*[i] ("SFAS 141"). Now, with a backdrop of rapidly declining valuations and a difficult economic outlook, many firms are failing "step one" of the goodwill impairment test required by Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* ("SFAS No. 142"). But, company executives, investors, and sometimes auditors themselves, are alarmed when they see the magnitude of the required write-down under "step two" of the goodwill impairment test. And, worse yet, many of these large write-downs could have been avoided if a proper purchase price allocation would have been completed in the first place.

The Two-Step Goodwill Impairment Testing Process

SFAS 142 requires that goodwill be tested for impairment at least annually using a two-step process. The first step is essentially a valuation of the business or reporting unit[ii]. If the business' fair value[iii] is greater than its carrying value (i.e., book value), then the company passes step one of the test and goodwill is not impaired. However, if the business' fair value is lower than its carrying value, then step two of the test must be performed.

Step two of the test is essentially a purchase price allocation in which the fair values of all the company's assets and liabilities must be subtracted from the fair value of the business to determine the residual fair value of goodwill and the amount of the necessary impairment charge.

Here's the key: the fair value of <u>all</u> of the company's assets must be determined, whether they are tangible or intangible, and whether they are recorded on the balance sheet or not. Also, impairment testing is a "one-way street" where write-offs are possible but write-ups are not. In other words, a company cannot re-allocate a purchase price or record the fair values of intangible assets as a result of the step two test; therefore, if a company recorded

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all of the intangible value in a business acquisition as goodwill, when, in fact, there were other intangible assets present that were not recorded, step two of the impairment test can lead to much higher-than-expected write-downs.

An Unfortunate Example

In 2005, ABC Enterprises ("ABC") acquires XYZ Company ("XYZ") for $100 million, consisting of $30 million in tangible assets and $70 million of intangible assets. ABC executives and their independent audit firm recognize that Statement of Financial Accounting Standards No. 141, *Business Combinations*[iv], requires that the company performs a purchase price allocation, recording all acquired assets and liabilities at their acquisition date fair values[v]; however, after arm-twisting from its client about not wanting to incur unnecessary fees just to "book intangibles that the bank doesn't include in its covenants anyway", the audit firm concedes and "blesses" an allocation with all $70 million of intangible value being attributed to goodwill.

A few years later, ABC is preparing for its year-end audit for December 31, 2008. The company's performance in 2008 was lackluster, and given the poor economic climate, expectations are for a difficult 2009 and 2010.

ABC management has conducted its own goodwill impairment testing since the XYZ acquisition, and has not taken an impairment charge yet. However, since the company almost failed step one in 2007, and performance worsened in 2008, both management and the audit firm acknowledge that a write-down of goodwill is a real possibility. Therefore, the audit firm is requiring that management outsource its goodwill impairment testing to a qualified, independent valuation practice.

In step one of the impairment test, the valuation firm determines that the fair value of the XYZ reporting unit is now $85 million compared to its carrying value of $95 million. Management is disappointed, but not surprised, and prepares to record a $10 million write-down of goodwill. BUT NOT SO FAST…In step two of the impairment test, the valuation firm determines that the fair values of ABC's customer relationships is $25 million, its trademarks and trade names is $15 million, its non-patented technology and know-how is $5 million; a total of $45 million of unrecorded intangible assets. All tangible assets are assumed to have a fair value at book value, thus step two of the impairment test resulted in a write-down of goodwill of

Calculation of Goodwill Impairment Charge

Fair Value of Enterprise	$85,000,000
Less: Fair Value of Net Tangible Assets	(30,000,000)
Less: Fair Value of Customer Relationships	(25,000,000)
Less: Fair Value of Trade Names	(15,000,000)
Less: Fair Value of Unpatented Technology	(5,000,000)
Residual Fair Value of Goodwill	$10,000,000
Carrying Value of Goodwill	$70,000,000
Required Impairment Charge	**$60,000,000**

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$60 million, as presented in the adjacent table.

Upon learning about the magnitude of the $60 million required hit to earnings and goodwill, management understandably becomes concerned, frustrated, and angry for three reasons:

(a) its bank has become a little uneasy with the company's performance and the news of a $60 million write-down (even though its bank covenants exclude consideration of goodwill) may not be well-received;

(b) management is concerned that a $60 million write-down will demonstrate to its shareholders that ABC dramatically over-paid for XYZ a few years ago; and

(c) the company only failed step one of the impairment test by $10 million, yet the company is being forced to take a $60 million hit to earnings and goodwill. Management did not thoroughly understand this issue when it neglected to complete a proper purchase price allocation a few years ago, and it places significant blame on its audit firm, which did not press the issue at the time and instead, chose the "easy way out" by not forcing its client to spend the money to get things done right the first time. After all, the fair value of the XYZ reporting unit is only $10 million less than its carrying value, yet there is a required impairment charge of $60 million.

It is very rare when a business combination does not result in the recognition and recording of at least two or three intangible assets.

Our Two Cents: It All Starts With the Allocation

The example above, which we have seen many times in our practice, illustrates the importance of conducting a thorough purchase price allocation at the time of an acquisition. Not only is it required by GAAP to record all intangible assets acquired in a business combination, but a thorough purchase price allocation will also properly reflect what was paid for in an acquisition and avoid major disasters like the example above. Additionally, the intangible assets that are recognized will be amortized over their estimated useful lives and will be subject to the much more lenient, almost impossible-to-fail tests under Statement of Financial Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*[vi].

In our experience, it is very rare when a business combination does not result in the recognition and recording of at least two or three intangible assets. After all, most businesses have valuable customer rela-

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tionships, trade names, technological know-how, or other valuable intangible assets (which is often why the acquirer finds the target to be an attractive acquisition). For improper allocations in the past, there is nothing that can be done and future impairment charges may be large. However, for future business combinations, we recommend spending the time and money to get the purchase price allocation right the first time. In many cases, the money spent will be well worth it if issues like the example above are avoided.

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[i] SFAS 141 has been revised, and now SFAS 141R becomes effective for acquisitions occurring after December 15, 2008. While there are many important changes in SFAS 141R, the requirement for a purchase price allocation does not change.

[ii] SFAS 142 requires that impairment testing be performed at the "reporting unit" level. A reporting unit is defined as an operating segment or one level below an operating segment. Many companies do not have segment reporting, thus the entire company is considered to be one reporting unit. For purposes of this example, we assume that ABC Enterprises places XYZ Company into a separate reporting unit.

[iii] The term "fair value" is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as the measurement date" (Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*).

[iv] SFAS 141 has been revised, and now SFAS 141R becomes effective for acquisitions occurring after December 15, 2008. While there are many important changes in SFAS 141R, the requirement for a purchase price allocation does not change.

[v] Including all assets, both tangible and intangible, regardless of whether the asset was recorded on the target company's financial statements, that meet certain requirements outlined in SFAS 141. SFAS 141 provides a sample list of intangible assets that meet these criteria.

[vi] SFAS 144 permits the use of an impairment test involving estimated future undiscounted cash flows. In our experience, it is very rare to have impairment of an intangible asset due to the nature of this test.

ABOUT US

GBQ Consulting specializes in Business Valuation, Mergers and Acquisitions, and Dispute Advisory and Forensic Services. Our Business Valuation group is one of the largest and most experienced in the Midwest. Professionals at our offices in Columbus (OH) and Indianapolis (IN) provide the following services:

- Transaction Support & Opinions
- ESOP & ERISA Advisory
- Succession & Wealth Planning
- Financial Reporting Services
- Corporate Planning & Assistance
- Expert Opinion Valuations

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