

Valuations Plus

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Goodwill impairment testing – Effect of the latest rules

You decide to grow through a merger or acquisition. You negotiate, you finance, you close, you integrate and you feel good that it's over and done.

Not so fast!

Acquisition accounting and the subsequent impairment testing of intangible assets will be with you for the rest of your days. The rules are changing, and the world is changing, and you're suffering through the worst recession this generation has seen.

Now what?

Changing accounting rules

Statement of Financial Accounting Standards 141 was revised (SFAS 141R) so that acquisitions after December 2008 have new rules in place that emphasize fair value recognition of assets and liabilities far more than the prior version.

Depending on who your "comparables" are, you might be facing impairment pressure even if you feel good about your financial performance this year.

For example, in-process research and development is now capitalized under SFAS 141R with an indefinite life and then tested annually for impairment. Acquirers will prefer to either shift value from it to amortizable assets, or over-shift value to it so they can take a first year impairment and be done with it.

A quick survey of current fair value literature suggests similar expectations from national market participants.

Most notably, capitalizing the value of contingent assets and liabilities under SFAS 141R is going to guarantee adjustments at remeasurement dates, as probability-weighted expected results turn into certain outcomes and cash flows. Also, SFAS 141R shortens the time frame for booking and reporting acquisitions – adding pressure to accept and go with initial estimates and results, thereby providing, *de facto*, for more revisionist SFAS 142 adjustments down the road.

SFAS 157 redefines how fair value is measured. "Exit pricing" – or the value at which an asset can be sold – is the new reference, no matter how much it costs now or cost to buy it then.

To the extent pre-SFAS 157 assets are remeasured using the new standard, it is less likely that goodwill is impaired because the other assets should have an implied downward revision in fair value.

Changing market forces

Companies have to wonder what stock markets will look like in the future. So much of enterprise value is determined by reference to markets that their state will have a great effect on whether your value will indicate impairment, or not.

At year-end 2008, the Dow was at 9,000, Nasdaq was at 1,600, and the S&P 500 was at 930. Recently, the Dow was north of 10,000, Nasdaq was past 2,100, and the S&P 500 was near 1,100. So, on a very broad scale,

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By CPAmerica guest columnist
Victor E. Jarosiewicz, ASA, CFA

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From the office of:

Why it's vital that you know the value of your business

Would you be surprised to learn that most business owners don't know the value of their own businesses?

About 58 percent of business owners had never had their business valued and did not anticipate doing so, according to a survey by the Illinois-based consulting firm George S. May International. And 41 percent believed they would not need a valuation unless they were planning to sell their company.

This belief can be short-sighted.

The reasons a business owner would choose not to have a valuation done run the gamut – from the assumed costs involved, to not believing it is necessary, to simply not understanding the impact of not doing so.

An accurate business valuation can be a valuable tool in many instances, and overlooking this critical part of your asset portfolio can lead to unintended consequences, both fiscally and personally. Many have faced burdensome taxes and personal animosities over perceived entitlement to a value of a business.

In addition to giving business owners important information about the quality, viability and possibilities about their businesses, business valuations are used for a variety of specific situations:

- ➔ **Estate, gift and trust planning.** A family-owned business is often a significant part of an owner's net worth. Proper estate planning can help to transfer interests in the family business to the next generation or other designated people. This can save tax dollars, as well as assist in the smooth transition of leadership in the business, thereby helping to secure the continued success and profitability of the company for generations to come. Without proper planning, the death of an owner may result in the death of a significant asset. A business valuation can be a means to accomplish the long-term goals of the owner.
- ➔ **Owner buy/sell agreements.** Whenever people go into business together, it is highly advisable that a formal buy/sell agreement be used to outline the process that will take place should an owner or owners decide to leave the business, become incapacitated or die. Part of that process would be the valuation of the business itself, to provide all of the owners with the proper numbers to effectuate a buyout. Having a valuation done on a regular basis provides the owners with the tools they need to plan for these future occurrences and possibly to obtain

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By CPAAmerica guest columnist
Lynne Broza, CPA/ABV, CFF



insurance coverage needed to fund a buyout. Long and costly litigation can result when a buy/sell agreement does not exist or fails to address how to value the business.

- ➔ **Mergers and acquisitions.** When one company buys out another or merges with it, a business valuation is essential to determine the fair price to be paid for this transaction. Having a valuation done could point out the various strengths and weaknesses of both companies and help assess if this is a transaction that is beneficial and cost effective. Having a regular valuation done can also help prospective sellers identify the right time to sell or merge and will provide the buyers with a base from which negotiations can begin.
- ➔ **Divorce settlements.** An ownership interest in a business that was acquired during a marriage is usually an asset subject to division among the parties in a divorce. This can often be one of the most significant assets the divorcing parties own. Therefore, a value needs to be placed on the business so that the parties can determine the distribution of the assets held in the marital estate. Often a business owner does not know the value or guesses at it – which can lead to poor results for one or both sides during a divorce litigation. With a business valuation in hand, the parties can then determine how to divide all of the marital assets.

An accurate business valuation can be a valuable tool. Overlooking this critical part of your asset portfolio can lead to unintended consequences, both fiscally and personally.

- ➔ **Litigation matters.** Over the life of a business, there may be times when legal matters are initiated. This could be for a variety of issues, such as shareholder disputes, insurance claims for lost business or possibly eminent domain proceedings. In all of these instances, the value of the business can be an integral part of the litigation. Armed with the knowledge of the value, the litigant can put forth a case based on careful analysis and documentation.

For larger companies, a business valuation would be needed if the company has an employee stock ownership plan (ESOP) or if the company wants to go public in what is known as an initial public offering.

Benjamin Franklin once wrote, "In this world nothing can be said to be certain, except death and taxes." He wrote this in 1789, and it stands true today. While death cannot be avoided, proper planning and use of a business valuation can often help alleviate tax burdens while also providing business owners with pertinent information that will assist them in a variety of situations. ■

Court rules date of valuation is firm – later information doesn't count

Taxpayers are often disappointed to discover that events that occur after the valuation date cannot be reflected in the earlier valuation of an asset.

This revelation is particularly difficult when the subsequent events may indicate that the value of the property was in fact overstated.

The court rejected the argument that the valuation of the stock should take into account the fraud that caused the price of the stock to be as high as it was on the distribution date.

Such was the case with Olafur Gudmundsson, who received no relief from a federal district court in New York. (*Gudmundsson v. U.S.*, 104 AFTR 2d 2009-XXXX, Oct. 26, 2009)

Gudmundsson was an officer of Aurora Foods, Inc. An initial public offering (IPO) of Aurora stock was made on July 1, 1998.

Pursuant to Aurora's employee incentive compensation plan, and in connection with the IPO, Gudmundsson received the right to the distribution of 73,105 shares of Aurora stock. Under terms of the agreement, the actual distribution of the stock took place on July 1, 1999.

On his 1999 income tax return, Gudmundsson included nearly \$1.3 million of compensation for receipt of the Aurora stock. The amount was calculated by multiplying the number of shares by the average per-share price of the Aurora stock on the New York Stock Exchange on July 1, 1999.

In late November 1999, Aurora announced that its earnings for the fourth quarter of that year would fall short of estimates. Following that announcement, Aurora's stock price fell more than 26 percent from Nov. 22 to Nov. 24, 1999.

In February 2000, Aurora's auditors informed Aurora's audit committee that they had discovered documents that raised some questions about Aurora's recent accounting practices. On Feb. 11, Aurora's board of directors appointed a committee to investigate those practices. The first public disclosure of any potential accounting fraud at Aurora came on Feb. 17, 2000, when the company announced that investigation.

On the same date, several members of Aurora's senior management, including its chairman and chief executive officer and its vice chairman and chief financial officer, resigned. From Feb. 17 to Feb. 22, 2000, Aurora's stock price fell roughly 50 percent.

In April 2000, Aurora announced it was reducing its previously reported pretax earnings for the last half of 1998 and the first three quarters of 1999 by more than \$81 million. In January 2001, the federal government announced indictments against several former Aurora officers, charging them with securities fraud, among other charges. The officers eventually entered guilty pleas. There is no allegation or evidence that Gudmundsson had any prior knowledge of the fraud, and he was not charged with any wrongdoing.

Gudmundsson subsequently amended his 1999 return, claiming a refund of more than \$300,000 plus interest.

In preparing the amended return, Gudmundsson used a value of \$7.5625, the per-share value of the Aurora stock on Dec. 31, 1999.

The IRS denied the refund claim, and Gudmundsson took his case to the federal district court. In the court case, Gudmundsson proposed three alternative dates for valuing the stock:

1. Dec. 31, 1999 – On this date, the six-month waiting period for bringing suit against an insider under §16(b) of the Securities Exchange Act of 1934 expired.
2. July 1, 2000 – On this date, restrictions under a securityholder's agreement entered into by Gudmundsson on April 8, 1998, in connection with the IPO and related issuance of Aurora stock expired.
3. A date determined by the court under §10(b) of the 1934 Act when Gudmundsson was free to sell without liability for trading on the basis of nonpublic information.

Gudmundsson also claimed that the publicly traded price of Aurora stock on any given date wasn't the proper measure of market value. Instead, the stock valuation should take account of the accounting fraud that had inflated the price of Aurora stock as of July 1, 1999.

The court denied Gudmundsson's refund claim based on the following conclusions:

- ▶ The court concluded that the restrictions of the securityholder's agreement did not subject Gudmundsson to a substantial risk of forfeiture within the meaning of §83 of the Internal Revenue Code.
- ▶ The court also found that Gudmundsson could have sold the stock on July 1, 1999, without running afoul of §16(b). The court concluded that the 6-month period under §16(b) had expired by the time that Gudmundsson received the stock in July 1999 because he had received the right to those shares on July 1, 1998.
- ▶ The court also found his contention that a substantial risk of forfeiture existed under §10(b) was an argument that had been previously rejected by the courts.

Finally, the court rejected the argument that the valuation of the stock should take into account the fraud that caused the price of the stock to be as high as it was on the distribution date.

Even when a corporation engages in a deliberate, massive fraud that conceals the true circumstances of the business, the price at which the stock could be bought and sold on a public exchange on the valuation date remains the fair market value of the stock. ■



Goodwill impairment testing *continued from front*

markets should suggest impairment is unlikely relative to the year-end 2008 measurement date for any company that has thus far survived this recession.

However, the story changes when one begins to consider sector indices and company size.

S&P 500 sector indices had a good year through early November 2009, except for telecommunications, particularly the non-wireless telecomm industry and utilities. All the other sectors were up for the year, with healthcare at +9.4 percent and information technology at +48.7 percent. However, the value of the median company in the S&P 500 index at that time was more than \$2 billion. S&P 600 companies were, on average, between \$200 million and \$1 billion in value. S&P 600 sector indices did not have such a good year, up overall only 11.3 percent, with financials down (-16.6 percent) to join utilities and telecomm as the biggest losers.

Information technology was up only +30.4 percent and healthcare +7.5 percent. In November 2009, 217 of the 600 companies were down, on average, -22.1 percent. Suddenly, depending on who your “comparables” are, you might be facing impairment pressure even if you feel good about your financial performance last year.

Dealing with change

So much changed during 2009 in the standards and in the economy that it makes the argument of no impairment that much more difficult to make.

Pay closer attention to your market environment and your comparables. Both have key metrics that combine with your own performance to affect the outcome of your impairment testing. Be ready to question comparisons from your company to these market factors.

Define your contingent assets and obligations and clearly track relevant data for them, and for your other intangible assets, to mitigate unexpected valuation adjustments.

Finally, use this new information to your advantage – this is a (maybe painful) learning year to prepare everyone for valuation impairment testing in the future.

Acquisition accounting, for all its good intentions and public purpose, has a perverse effect on the management of results. Public companies seek to maximize earnings per share. Private companies seek to minimize tax liabilities.

It remains to be seen how the economy and the effects of new accounting standards will play out in coming years. ■

The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation. Please be advised that, based on current IRS rules and standards, the advice contained herein is not intended to be used, nor can it be used, for the avoidance of any tax penalty assessed by the IRS.