

Public Company *Insights*

Writing off goodwill

*A weak economy makes
unscheduled testing necessary*

Directors' compensation:
A delicate balancing act

Why fairness opinions matter

Don't let thieves steal
your corporate identity



August/September 2009

Writing off goodwill

A weak economy makes unscheduled testing necessary

In today's volatile economy, companies must pay close attention to goodwill impairment. Under current accounting rules, companies are required to test acquired goodwill for impairment annually. But unscheduled impairment tests may be necessary if certain triggering events — including a “significant adverse change ... in the business climate” — have a negative impact on fair value. These days, most companies should be screening regularly for goodwill impairment, and, if necessary, recognizing impairment losses.

Interim testing

When a company acquires another company, the purchase price is allocated based on the fair values of the acquired assets. Any amount by which the purchase price exceeds the value of the target's identifiable net assets is treated as goodwill.

A triggering event doesn't automatically require your company to write off goodwill. It simply means there's a potential impairment.

Under previous accounting rules, goodwill was treated as a “wasting asset,” which meant it was amortized over its useful life, up to 40 years. In 2001, however, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, which provides that goodwill be tested annually for impairment (at the reporting unit level) and written down only if its carrying amount exceeds its fair value.



SFAS 142 also requires companies to test for impairment between annual tests if “an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.” Such triggering events include:

- A significant adverse change in legal factors or the business climate,
- An adverse regulatory action,
- Unanticipated competition,
- Loss of key personnel, or
- An anticipated (more likely than not) sale of a reporting unit or significant portion of a reporting unit.

In the current economic climate many — if not most — companies will find that a triggering event has likely occurred, requiring interim testing for impairment.

Two-step process

A triggering event doesn't automatically require your company to write off goodwill. It simply means there's a potential impairment that requires further investigation. Determining the existence of impairment is a two-step process. In step one, you determine the fair value of each reporting unit and compare that value to its carrying amount, including goodwill. If a unit's fair value exceeds its carrying amount, goodwill isn't considered impaired and step two isn't necessary.

If, on the other hand, a unit's carrying amount is greater than its fair value, you must proceed to step two. There's a common misconception that the excess of a unit's carrying amount over its fair value is equal to the amount of goodwill impairment. But the fair value shortfall is merely an indication of possible impairment and you can confirm impairment only by following step two.

In step two, you compare the "implied fair value" of a unit's goodwill to its carrying amount. Performing this test is a complex process and typically requires the use of outside valuation expertise. It involves treating a unit's fair value as if it were the purchase price in a business combination. Then that value is allocated among the unit's assets and liabilities — including any intangible assets (other than goodwill).

If the unit's step one fair value exceeds the value allocated to these net assets under step two, the excess is the implied fair value of its goodwill. The excess, if any, of the carrying amount of goodwill over its implied fair value is the amount of the impairment loss that should be recognized.

A company potentially could go through step two and conclude that goodwill hasn't been impaired. This might happen, for example, when the fair

Hunting for goodwill

Just because step one of the SFAS 142 test indicates potential impairment doesn't necessarily mean that a company's goodwill is impaired. Suppose the step one analysis determines that a reporting unit's fair value is \$10,000 and its carrying value is \$12,000, including \$3,000 in goodwill. Step one indicates a potential impairment of \$2,000. It's necessary, therefore, to proceed to step two.

Step two's analysis determines that the fair value of the unit's net assets is only \$7,000, making the implied fair value of goodwill \$3,000 (\$10,000 - \$7,000). Because the implied fair value of goodwill is equal to its carrying value, goodwill hasn't been impaired. The company will need to apply other accounting rules to determine whether to record impairment on certain assets, such as long-lived assets.

values of certain tangible or identified intangible assets have declined. (For an example, see the sidebar "Hunting for goodwill" above.)

Value judgments

As the above suggests, fair value plays an important role both in accounting for business combinations and testing for goodwill impairment. You're probably aware that the rules for measuring fair value have been the subject of intense controversy in recent months. And valuing financial assets in illiquid and inactive markets is particularly challenging right now, despite recent FASB guidance on the subject.

So if you're planning a merger or acquisition, or testing for goodwill impairment, enlist the help of a qualified valuation professional who knows how to address fair value issues. The impact of SFAS 142 will depend to a great extent on the selection of reporting units and allocation of goodwill and other assets among them. You have some flexibility in making these allocations, and a CPA can facilitate the process. ■

Directors' compensation: A delicate balancing act

After passage of the Sarbanes-Oxley Act of 2002, the director's role took on greater responsibility and heightened exposure to liability. It's no surprise, then, that directors' compensation has grown steadily over the last seven years. Companies, however, need to regularly review directors' compensation to ensure it remains reasonable.

Not enough or too much?

Directors' compensation isn't a private matter between your company and its board members. In today's tumultuous economic environment, shareholders, the media and other interested parties are paying close attention to the compensation paid to both officers and directors. What's more, SEC rules now require detailed disclosures about directors' compensation and your company's process for determining it.

All public companies, therefore, need to evaluate their directors' compensation programs periodically, focusing in particular on nonmanagement directors. The pay should be enough to compensate directors for the responsibilities and risks they assume, but not be so much that it jeopardizes their independence or attracts public censure.

Questions you should ask

Consider the following as you review your directors' compensation program:

Compensation amount. There's nothing wrong with paying healthy fees or retainers to directors, so long as these amounts are reasonable in light of their duties, the risks they assume and directors' fees at comparable companies. It generally makes sense to pay higher compensation to directors whose roles involve greater responsibility, such as chairing a committee or serving on audit, compensation or nominating/governance committees.

Because there's an inherent conflict of interest when the board determines its own compensation, directors must document the process thoroughly with market data and detailed descriptions of roles.

Form of cash. Many companies are moving away from traditional meeting fees to paying annual retainers. This helps reinforce the idea that a director's oversight responsibilities extend beyond meeting attendance. It also helps companies avoid confusion over issues such as what constitutes a "meeting" (for example, do phone meetings count?) and how to compensate a director for partial attendance.

Mix of cash and equity. Most companies pay a portion of directors' compensation in equity to ensure that their interests are aligned with the shareholders'. There's no magic percentage that companies should use, provided the equity portion is large enough to be "meaningful."



Form of equity. Traditionally, companies have used stock options, but options have become less popular in recent years for a couple of reasons. First, the recent backdating scandal has made many people suspicious of option programs. And second, many view options as less effective motivators because they have no downside risk and may encourage a short-term approach that focuses on the company's stock price.

Because there's an inherent conflict of interest when the board determines its own compensation, directors must document the process thoroughly.

Restricted stock may be a better alternative because it encourages directors to take a long-term view that better aligns their interests with those of shareholders. To ensure this alignment, many

companies require directors to maintain a certain level of stock ownership for as long as they serve on the board.

Additional perks. If your directors' compensation includes perquisites, such as cars or country club memberships, consider whether they send the wrong message about director independence. Most perks have no relationship to a director's performance.

Review your program

You have some flexibility in evaluating your current compensation program and determining whether it's reasonable. The important thing is that you work to make pay commensurate with directors' levels of responsibility and risk, and that you be sure your program aligns the interests of directors and shareholders. Just make sure you thoroughly document the process of setting directors' compensation, and your program is more likely to withstand shareholder and government regulator scrutiny. ■

Why fairness opinions matter

As a result of the current financial crisis, the actions of corporate executives and directors are coming under greater scrutiny. Shareholders, lenders, the government and general public are, more than ever, highly suspicious of transactions that benefit corporate insiders. In this environment, fairness opinions can be an invaluable tool for easing stakeholder concerns about your company's proposed transactions and avoiding shareholder disputes and litigation.

An independent perspective

A fairness opinion is simply a written report by an independent financial expert stating that a proposed transaction (typically, a merger or

acquisition) is fair, from a financial perspective, to the company's shareholders.

Traditionally, fairness opinions have been prepared by investment banking firms. But in the current climate, a fairness opinion may carry more weight with shareholders if it's prepared by a qualified, independent CPA or business valuator. Unlike investment bankers, these professionals have no financial interest in the proposed transaction and don't stand to benefit if it's consummated.

Fair value for all

Although fairness opinions usually are associated with mergers and acquisitions, they're

useful whenever there's a risk that minority shareholders will challenge a transaction's fairness. For example, related-party transactions, restructurings, recapitalizations, stock buybacks and employee stock ownership plan transactions might all benefit from a fairness opinion.

Unlike investment bankers, CPAs have no financial interest in the proposed transaction.

Under current accounting rules, measuring fair value can be challenging. Fairness opinions are particularly useful, therefore, in situations where a transaction's fairness depends on the value of stock or other assets that aren't actively traded or for which the market has become inactive. A fairness opinion may also be desirable in situations where there are competing offers with different structures, in single-bid or no-bid situations, if the company's financial performance has been poor, or if board members disagree about the transaction's merits.

Multiple benefits

A competent, independent fairness opinion offers an objective, unbiased assessment — for both shareholders and management — of whether a proposed transaction would be in the company's best interests. It also provides some assurances to minority shareholders that the proposed transaction is fair to them and that corporate insiders aren't attempting to enrich themselves at the minority's expense.

A fairness opinion can further protect corporate leaders under the "business judgment rule." In accordance with the rule, a court will defer to the decisions of corporate officers or directors if they exercised due care, were informed of all the relevant facts, acted in good faith and reasonably believed that their actions were in the corporation's best interests.

An effective tool

Fairness opinions aren't required by law, nor do they determine or verify a company's value or fair price. They may, however, be the most effective tool available for avoiding shareholder litigation and protecting corporate leaders in the event litigation is unavoidable. ■

Don't let thieves steal your corporate identity

Virtually everyone is familiar with personal identity theft. It's one of the fastest-growing crimes in the U.S., resulting in billions of dollars in financial losses every year.

Individuals aren't the only ones vulnerable, though. Corporate identity theft is a growing

problem and in many cases, corporations — especially large ones — are more attractive targets for identity thieves than consumers. Not only do large corporations have more money, but they often don't notice fraud has occurred until after they've suffered significant damage to their reputation and bottom line.

Identity scheming

Criminals have several methods of hijacking a corporation's identity for personal gain. For example, thieves might:

- ▶ Create counterfeit checks using your company's banking information,
- ▶ Send false purchase orders in your company's name (using a different "ship to" address) to vendors your company uses,
- ▶ Send you fake correspondence or forms purportedly from your bank to obtain confidential information and steal money from your bank accounts,
- ▶ Apply for loans or credit from others under your company's name,
- ▶ Create Web sites that have a similar domain name and look to yours, and use them to steal personal information from your customers or sell them nonexistent products, or
- ▶ Set up a parallel company or subsidiary using your company's name or a similar name, and sell products to your customers.

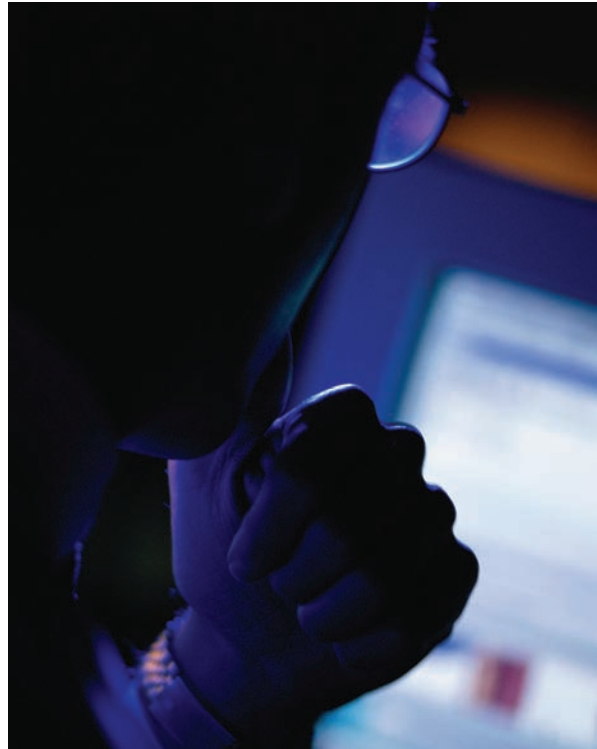
In one particularly outrageous case a few years ago, thieves established a fraudulent company under the name of electronics giant NEC and used its brand identity to create and sell an entire line of counterfeit products.

What you can do

Fortunately, companies have the means to combat corporate identity theft, starting with good internal controls. These rules and procedures are essential to protecting banking and other sensitive corporate information from leaking to criminals and, at the same time, make employee fraud more difficult to perpetrate.

If you haven't already, consider adopting anti-counterfeiting techniques to protect corporate documents. Watermarks, intricate logos, distinctive colors and special papers with built-in security features can help prevent check tampering and photocopying.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. © 2009 PCIAS09



Also, ask your bank about increasing your checking account's security with a positive pay system. This system allows you to review potentially fraudulent checks (those that don't match a list you've provided) before they're paid. And be sure that you verify all forms and other correspondence that appear to be sent from your bank and request confidential information.

Vigilance is key to preventing identity theft. Even if your company's identity seems secure now, you should regularly scan the Internet for e-mail addresses or domain names that are similar to yours. And review corporate filings in the states in which you do business for company names that are identical or similar to yours, or purport to be one of your subsidiaries.

Protect your bottom line and reputation

Sophisticated schemes are difficult to spot unless you're proactively looking for and protecting against them. Every corporation needs a corporate identity theft program. Without one, you risk not only significant financial losses, but also lasting damage to your company's reputation. ■