

Client Alert

Latham & Watkins Corporate Department

Declining Market Capitalizations and the Impairment of Goodwill

As a result of the deepening economic downturn, more than a quarter of the S&P 1500 companies were reported to have market capitalizations below the book value of their assets.

The staff of the US Securities and Exchange Commission (SEC) interprets a decline in market capitalization below book value as indicating that goodwill and other intangible assets should be tested for impairment under SFAS 142.¹ Impairment testing does not necessarily lead to recognition of an impairment loss but does present the possibility of incurring such a loss.²

Companies with book value in excess of market capitalization and companies with a material amount of goodwill should be aware of recent SEC staff speeches regarding the application of SFAS 142 in the circumstances companies face in the current market environment.³ These speeches, as well as recent SEC comment letters, suggest that companies with a material amount of goodwill on their balance sheets should understand how SFAS 142 can affect them in the current market environment.

In particular, if you still have a market capitalization in excess of book value, we suggest taking proactive steps to mitigate the effects of future write-downs of goodwill. If you already have a market capitalization less than book

value, we suggest taking steps to ensure that your next earnings release and periodic report includes appropriate disclosure surrounding a potential impairment.

SFAS 142 and Market Capitalization

SFAS 142 provides that goodwill must be tested for impairment annually and between annual tests when events occur that indicate an impairment or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.⁴ A significant adverse change in the business climate is one indicator of a potential impairment. A sustained drop in market capitalization below book value may suggest, or result from, the occurrence of a significant adverse change in business climate.

Impairment testing is a two-step process. Step one involves comparing the fair value of a company's reporting units with their carrying amount, including goodwill. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill test is required to measure the amount of impairment loss.

Step two of the process, which is far more time intensive, involves a valuation of all of the assets of the reporting units,

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as if the reporting unit had just been acquired, and comparing that with the carrying amount. If the carrying amount of reporting unit goodwill exceeds the fair value of that goodwill, an impairment loss must be recognized in an amount equal to that excess.

No bright-line rule requires that a company with a market capitalization less than book value must test for or take an impairment charge. Rather, a company should evaluate a decline in stock price relative to the market and its industry as a whole and consider factors such as the duration and severity of the stock price decline.

Factors that may counsel against the necessity for a test include a short-term spike in short-selling or external market or industry events that prompt unusual volatility in the company's stock. However, the larger and more sustained the deviation between the book value and market capitalization, the more likely it is that an interim test of impairment is appropriate. Alternatively, if the company determines an interim test of impairment is not necessary or that a full valuation of goodwill is not required, the company will need more evidence to justify carrying a material amount of goodwill and reconciling the company's book value to its market capitalization.

SFAS 142 does not require that goodwill be marked to market, but rather requires a company to evaluate the fair value of its reporting units against the carrying value of the reporting units. In deciding whether or not to test reporting units for impairment, market capitalization is often viewed as the best available proxy for the fair value of the aggregated reporting units. If market capitalization is below book value for a prolonged period of time with a significant decline, an impairment may have occurred at one or more reporting units.

When market capitalization has fallen significantly, a company should consider whether this is an indicator that the

carrying value of its reporting units has been impaired. Market capitalization does not equate to the total fair value of a company's reporting units, however, and a company's decision whether to test for impairment should depend on its own facts and circumstances. Absent special circumstances, though, after considering market capitalization over a reasonable period of time, a prolonged and significant decline in market capitalization is likely to constitute an indicator of impairment triggering the need to test for an impairment of goodwill. The SEC staff views this type of decline in market capitalization as an indicator that the underlying business occurring within the reporting units may be suffering.

Companies With Material Amounts of Goodwill

A company with a material amount of goodwill on its balance sheet that currently has a market capitalization in excess of book value should take affirmative measures to prepare for any future impairment of goodwill. Companies with a material amount of goodwill should consider updating their disclosure to include additional risk factor disclosure describing the goodwill and addressing the possibility of future material impairments.

The larger the difference between market capitalization and book value that is attributed to a control premium, the more likely it is that the company will face increased SEC staff scrutiny.

No precise rule governs the reasonableness of a control premium when reconciling book value to market capitalization. Instead, the exact percentage of a reasonable control premium will vary depending on a company's specific facts and circumstances. The company's auditors and experienced securities counsel can assist in developing the necessary framework for analysis of these issues in determining an appropriate control premium.

When Book Value Exceeds Market Capitalization

A company that has already suffered a decline in market capitalization below book value should recognize that this is an indicator of impairment and begin the process of testing its goodwill for impairment. Where the recognition of an impairment loss is probable and can be reasonably estimated, it should be presented in the financial statements accompanying its next earnings release and periodic report.

To the extent a full step-two valuation under SFAS 142 has not been completed, such disclosure should indicate that the impairment amount is an estimate and subject to further adjustments, which may be material. Any adjustments to that estimate may be recognized in subsequent reporting periods.

Companies should also address the impairment in their management's discussion and analysis of financial condition and results of operations (MD&A) disclosure. This discussion should include the reasons for the impairment loss, such as changes in projected future cash flows due to the current economic climate, the timing of recognizing the impairment loss, why it was not necessary to recognize the loss in prior quarters and, if the impairment resulted from an interim test, a description of the indicator that required the interim test.

A company should also update its risk factors to account for the uncertainty in estimating an impairment under current market conditions. A good risk factor will indicate that future impairments of goodwill are possible. Additionally, the company's critical accounting policies should describe the company's analysis and assumptions pursuant to SFAS 142.

As described in SFAS 142, the final amount of the impairment charge will be determined by step two of the impairment test. The results of such a test will necessarily involve the application of judgment. Companies are cautioned against both taking too small or too large of an impairment charge. Furthermore, reversal of a recognized goodwill impairment is prohibited once the measurement of that loss is recognized.

Conclusion

The SEC staff recognizes that, in the current market environment, many companies may need to test for impairment of goodwill and recognize an impairment loss.

Given the continued turmoil in the markets, companies with market capitalizations in excess of book value should prepare for the possibility of a goodwill impairment charge that could result if the market continues to decline.

Companies with market capitalizations already significantly below book value should recognize the likely need to test for impairment of goodwill. Any related disclosure regarding an impairment charge should provide investors with an understanding of why this was the right time to recognize the loss and highlight the possibility of future impairments.

Finally, companies facing these issues under SFAS 142 should carefully review related disclosure and legal considerations. For example, companies in this situation should also review their indenture and bank covenants and consider other potential collateral consequences from an impairment charge.

Endnotes

¹ Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets." A company that concludes, outside of the process of preparing financial statements to be included in a periodic report, that SFAS 142 or other generally accepted accounting principles require a material charge for impairment of goodwill or other assets must file a current report on Form 8-K disclosing the impairment charge and related information under Item 2.06 of Form 8-K.

² A recent survey by Latham & Watkins LLP of quarterly reports on Form 10-Q for the quarter ended September 30, 2008 identified approximately 250 companies disclosing material charges for impairment of goodwill.

³ Steven C. Jacobs, Associate Chief Accountant of the Division of Corporation Finance, "Goodwill Impairment Disclosures," Slide Presentation to the American Institute of Certified Public Accountants (AICPA) (Dec. 9, 2008), available at <http://www.sec.gov/news/speech/2008/spch120908wc-slides.pdf>; Robert G. Fox III, Professional Accounting Fellow, Office of the Chief Accountant, "Current SEC and PCAOB Developments," Remarks to the AICPA (Dec. 8, 2008), available at <http://www.sec.gov/news/speech/2008/spch120808rgf.htm>. Although the views expressed in these speeches are not official policy statements of the SEC and do not necessarily reflect the official policy or views of the SEC, they provide important insights into how the SEC staff will apply SFAS 142.

⁴ Testing is conducted at the reporting unit level, which is generally one level down from a registrant's operating segment under Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information," so the registrant should carefully consider its segment reporting in connection with where goodwill and other intangible assets are tested.

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