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The Effects of FASB Statement No. 121 on Financial Statements

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THE CARL AND WINIFRED LEE HONORS COLLEGE

CERTIFICATE OF ORAL EXAMINATION

Karen Courtade, having been admitted to the Carl and Winifred Lee Honors College in 1996, successfully presented the Lee Honors College Thesis on April 2, 1998.

The title of the paper is:

"What Effect has FASB 121 had on Financial Statements?"

Dr. Lisa Martin
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The Effects of FASB Statement No. 121 on Financial Statements

Karen Courtade

Lee's Honors College Thesis

April 2, 1998

The Effects of FASB Statement No. 121 on Financial Statements

Introduction

As managers contemplate the adoption of SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of*, most will be considering the impact of these new requirements on their particular reporting situation. This effect is important to managers because whenever the Financial Accounting Standards Board (FASB) issues a new statement, financial statements need to be in compliance with Generally Accepted Accounting Principles (GAAP). New requirements also cause tax and auditing concerns, effects on financial statement users, and extra costs to companies involved.

The FASB's intent in issuing SFAS 121 was to force more consistency among companies in recording long-lived asset writedowns. However, some of its provisions are broad enough to enable management to still formulate aggressive or conservative approaches to the recognition of asset impairment losses. By reviewing existing literature on the topic, collecting and analyzing data, and drawing some conclusions based on what I have found, I have conducted this research project about how FASB 121 has actually affected financial reporting.

The Path to FASB Statement 121

The accounting profession has long had standards on the impairment of current assets and has reference for certain long-lived assets to be disposed of. Only recently

have there been rules for the impairment of long-term assets that are going to be continued to be held and used. Before the issuance of SFAS 121, companies had generally written down an asset when there was evidence of permanent impairment in the ability to fully recover the asset's carrying amount (Titard and Pariser 1996). In reality, practice was not consistent between different companies. For example, consider the following statement: "Eight-hundred companies reported some form of asset impairment in their Earnings Report in the *Wall Street Journal* in 1994, up from 677 in 1993 and only 302 in 1992. These charges to income have been criticized as well-timed ploys to reduce asset values in order to boldly boost management's future income-based bonuses or to discretely eliminate the goodwill capitalized when management overpaid for acquisitions or hopefully encourage increased earnings-based estimates of stock price when non-cash depreciation and amortization charges are eliminated" (Scotfield 1996). With the adoption of FASB Statement No. 121, management has less discretion in the timing and the amount of charges for asset impairments.

Although SFAS 121 also covers assets to be disposed of, Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequent Occurring Events and Transactions* includes some of the assets in this area. SFAS No. 121 does not supersede APB No. 30 in this regard, but applies to all long-lived assets and certain identifiable intangible assets not covered by APB No. 30. The areas covered by APB Opinion 30 are extraordinary items, disposals of a segment of a business, and other unusual or infrequently occurring events and transactions that are not extraordinary items. APB Opinion No. 30 requires assets to be disposed of to be valued at the carrying amount

or net realizable value, whichever is lower. Assets that are not covered by Opinion 30 will continue to be reported at the lower of carrying amount or net realizable value and continue to follow SFAS 121 provisions (SFAS No. 121, par.15). The information provided in my thesis regarding the disposal of assets not covered by APB 30 is similar to how to account for assets to be held and used, with a few notable exceptions. As one can see, the issuance of a standard to acknowledge the impairment of long-lived assets was greatly needed.

An Overview of FASB Statement 121

FASB Statement No. 121 affects any company that might have impaired assets, such as long-lived assets, certain identifiable intangible assets, and goodwill related to those assets to be held and used and long-lived assets and certain identifiable intangibles to be disposed of. FASB 121 does not apply to financial instruments, long-term customer relationships of a financial institution, mortgages and other servicing rights, deferred policy acquisition costs, and deferred tax assets (Titard and Pariser 1996).

Impaired assets are those that have a carrying value on the balance sheet that may not be recoverable. Impairment testing of assets is required only when events or circumstances indicate carrying amounts may not be recoverable. Some examples of these indications include: reduction in the extent to which a plant is used, dramatic change in the manner in which an asset is used, significant physical change in an asset, substantial decrease in the market value of an asset, a forecast showing lack of long-term profitability, and costs in excess of amount originally expected to acquire or construct an asset. If the carrying amount of an asset exceeds an undiscounted cash flow of the asset

or group of assets in review, an impairment loss equal to the difference between the carrying amount and the asset's estimated fair value is recognized. If the cash flows exceed the carrying amount, the asset is not impaired and no loss is recognized. The provisions of this statement need not be applied to immaterial items (Titard and Pariser 1996).

FASB Statement No. 121 is effective for fiscal years beginning after December 15, 1995, although earlier application is encouraged. Restatement of previously issued financial statements is not permitted and impairment losses resulting from application should be reported in the period in which recognition criteria are first applied and met. The initial adoption should be reported as the cumulative effect of a change in accounting principle (Titard and Pariser 1996), and a business entity shall report the amount of the cumulative effect in the income statement between the captions "extraordinary items", if any and "net income" (SFAS No. 121, Par. 13). A description of the assets impaired, the circumstances leading to the impairment, the amount of the loss, how it was determined, and the business segments affected should be included in the footnotes.

Although there are many more details to SFAS 121, this section is intended to give the reader an overview of the Statement. The next section of this paper gives more detail about some of the underlying problems and issues faced by companies and financial statement users. After I have discussed the many concerns already documented, then I will begin to recognize many of the issues not yet documented as of the time of my research.

Interaction of FASB Statement 121 with Financial Statements

Recognition and Measurement

One of the most interesting and controversial aspects of the statement is the requirement for recognition and measurement of the impairment. The amount of the recognized loss is not the difference between the carrying amount and the expected future cash flows, as might be expected based on the test for impairment. Rather, it is the amount by which the asset's carrying amount exceeds fair value (SFAS No. 121, par. 6). To review, the fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than a forced liquidation sale. Quoted market prices in active markets is the best evidence of fair value and should be used as the basis of measurement if available. If quoted market prices are not available, the estimate of fair value should be based on the best information available in circumstances (SFAS No. 121, par. 7).

The FASB's reason for these recognition and measurement practices is actually very straightforward. The FASB defended itself by concluding that a company's decision to continue operating rather than sell an impaired asset means management believes using the asset is more beneficial than selling it. Fair value is the best measure because it was consistent with management's decision process. The FASB also felt a new cost basis had to be recognized and that fair value of the impaired asset was the most appropriate measure, because fair value generally was used when a new cost basis was established. The Board believed that using fair value to measure an impairment was not a departure from the historical cost principle, but rather consistent with principles practiced

whenever a cost basis for a newly acquired asset must be determined (Titard and Pariser 1996).

Asset Grouping

Another interesting issue is how assets should be grouped when measuring for impairment. SFAS 121 states that "assets should be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets" (SFAS No. 121, par. 8). Thus, assets that are used jointly to produce cash flows for the business are examined together, whether or not there are separate market values for each individual asset. If declines in some asset values are offset by increases in other values in the group, there is no asset impairment to recognize. In this way SFAS 121 matches the management decision-making process with the accounting requirements.

Although that preceding description may make asset grouping seem easy, one must remember that determining the lowest level of grouping requires considerable judgment. Grouping assets is situation specific and should be evaluated on a case-by-case basis. As groups become broader, more judgement is involved and the opportunity is greater to combine assets with fair values in excess of carrying amounts with those that are impaired. Although this is the type of practice the FASB was trying to avoid, one can see that SFAS 121 provides opportunity in this aspect. Also, in limited circumstances, the impairment test is applied at the entity level because the asset being tested has no identifiable cash flows largely independent of other groupings (Nurnberg and Dittmar 1996). In this situation, it is most likely that there will be assets with fair values in excess

of carrying amounts that will be combined with impaired assets, and thus, no impairment will be recognized. This may create some inconsistency among other firms who may have identifiable cash flows independent of other groupings.

Asset grouping may still seem simple enough, but accounting for goodwill is also a part of asset grouping. If the asset being tested for recoverability was acquired in a business combination accounted for using the purchase method, the goodwill that arose in that transaction shall be included as part of the asset grouping in determining recoverability. If some, but not all of the assets acquired in that transaction are being tested, goodwill shall be allocated to the assets being tested for recoverability on a pro rata basis using the relative fair values of the long-lived assets and identifiable intangibles acquired at the acquisition date. This shall be done unless there is evidence to suggest that some other method of associating the goodwill is more appropriate. In instances where goodwill is identified with assets that are subject to an impairment loss, the carrying amount of the identified goodwill shall be eliminated before making any reduction of the carrying amounts of impaired long-lived assets and identifiable intangibles (SFAS No. 121, par. 12). Goodwill not related to acquired assets subject to SFAS 121 is accounted for using APB Opinion 17, *Intangible Assets*. Since Opinion 17 does prescribe a method for measuring impairments, companies may use the cash flow method of SFAS 121, but are not required to do so (Nurnberg and Dittmar 1996).

Cash Flow Measurement

The standard allows management considerable flexibility in how it measures cash flows. "This feature is favorable because it lets management use the normal techniques

and assumptions that reflect the operating environment rather than impose arbitrary procedures that might be more costly and burdensome to implement." However, such flexibility could create improper reporting problems. For example, management may want to overstate cash flows to avoid write-offs or understate cash flows for long-term effects (Titard and Pariser 1996).

Depreciation Policies

The next area will show how depreciation policies can be linked to SFAS 121. For instance, assets whose values decline uniformly over time will avoid impairment classification because the carrying value will remain below undiscounted future net cash flows. However, assets whose values decline faster in their earlier years may be matched with an accelerated method to avoid impairment classification (Scotfield 1996). It is not clear whether the FASB intended this behavior by firms. Although depreciation was not meant to be linked to the value of an asset, but rather a method of cost allocation, this may actually be better matching of costs to the asset's usefulness. If the asset's fair value is declining rapidly, it is most likely a result of obsolescence over time since many assets are used more frequently in the beginning of their life, which it would be best depreciated by an accelerated method. It may not matter which method is used in regard to SFAS 121 as long as the excess carrying amount of an asset does not exist in a company's financial statement presentation.

Implementation Cost Versus Benefits

The previous discussions on various issues of companies leads to the question of implementation costs versus benefits. Estimating future cash flows can be time-consuming and expensive. Yet, many companies already have capital budgeting policies that require a review of assets to determine whether original projections are met. Also, it is in a company's economic interest to review and dispose of nonproductive assets (Titard and Pariser 1996).

Tax Effects

Another issue that should be addressed is the tax effect. The determination of when an asset should be written down for financial statement purposes is not necessarily consistent with when a loss can be deducted for income tax purposes. If the asset is sold, most management accounting systems will identify the transaction, and an accounting entry reflecting the sale will be recorded. Thus, the appropriate income tax provision for the gain or loss will be triggered by the accounting entry. However, if the asset is not sold, the asset is still in use, or has been discarded, scrapped, or otherwise abandoned, most management accounting systems will not routinely identify these events. Thus, the appropriate income tax provision for the gain or loss may not be recorded properly (LaSalle 1996).

Besides being concerned about whether or not an accounting system can recognize the impairment loss, we should look at the actual tax reporting of the issue. The first item to remember is if a loss is sustained, it is deductible only in the year sustained. Also, a mere decline in the value of an asset normally is not deductible. Thus,

a partial write down of an asset for financial statement purposes generally would not create a deduction for tax purposes. Often a sale or exchange of the asset would be necessary to recognize the loss associated with a partially impaired asset. However, there are tax provisions that permit companies to deduct losses on assets that have not been sold or exchanged. Although this goes beyond the scope of my paper, information regarding this can be found in the Internal Revenue Code Section 165 which permits a deduction for losses associated with the abandonment of nondepreciable assets. Also, losses associated with depreciable assets are governed by Section 167 and/or Section 168 (LaSalle 1996).

Auditing Concerns

The last area of discussion in this section is auditing concerns. The reason for such detail in this area is because this is an area of focus for my career. It is interesting to see the extra planning and actual evaluation of management's compliance with FASB provisions an auditor should do for the implementation of a new SFAS statement.

An auditor should begin by discussing with management the policies and procedures that are in place to help identify indicators of asset impairments and to determine whether the events or circumstances that have occurred would require management to evaluate whether an asset is impaired. If there are no asset impairment indicators, auditors should document that fact and conclude that impairment testing is not necessary and reviewing a budget, preparing a cash flow analysis, and forecasting future income would not normally be required. If events or circumstances indicate an asset's

carrying amount may not be recoverable, an auditor should examine management's test for impairment (Nurnberg and Dittmar 1996).

Management's test for impairment should include reviewing management's estimates of expected cash flows, determining that the major assumptions used in the underlying analysis are adequately supported and documented as to rationale and reasonableness, and developing an independent expectation to corroborate the estimate's reasonableness. Next, the auditor should verify the time period used for cash flows is reasonable when compared with the asset's remaining depreciable life, determine that the cash flow estimates are at the lowest level for which there are identifiable cash flows, and consider any related goodwill that may be associated with assets being tested for impairment. After the initial procedures have taken place, the auditor should consider management's objectivity and expertise in preparing the analysis and the reasonableness of previous ones. Also, the auditor should review subsequent events or transaction occurring before completion of fieldwork (Nurnberg and Dittmar 1996).

Although that covers the bulk of what an auditor should do, there are a few other considerations. For assets held for sale, the auditor should verify that they are recorded at the lower of carrying amount or fair value less cost to sell. Also, they should examine corporate minutes and other evidence of management's commitment to dispose of assets, consider whether the evaluation of the carrying value of specific productive assets or segments has implications for evaluating the entity as a going concern under SAS No. 59, and verify that all required financial statement disclosures are made in accordance with SFAS 121. Lastly, the auditor should obtain written representations from management acknowledging its responsibility for the significant assumptions used in forecasting future

cash flows and that the amount of any recorded impairment represents management's best estimate or a positive statement that no asset impairment needs to be recognized (Nurnberg and Dittmar 1996).

Description of the Research Methods

Although I have discussed many situations that the company, financial users, tax accountants, and auditors must consider, there is more to SFAS 121 that needs to be discussed. The question of this paper is how FASB Statement 121 has actually affected financial reporting. I plan to show some of the actual effects of SFAS 121 by looking at financial statements after the adoption of the new standard.

Using the Compact Disclosure Database for the 1997 year, I used three terms in order to find financial statements that discussed SFAS 121, which were a) "No. 121" b) "Long-lived assets", and c) "Impairment" within three words of "assets". This search gave me 4010 hits, although a few were not able to be used because not all pertained to FASB Statement 121. Most companies reported that SFAS 121 was immaterial to their financial statements. In order to be consistent, the only financial reports included were the statements that contained the report of the initial adoption.

The goal of the research was to find out how SFAS 121 affected financial reporting. By gathering descriptive data on the 328 material financial statements, specific issues that seemed interesting were reviewed. The data that was collected on each company was the company's name, CUSIP number, SIC Code, the type of business, total assets, shareholder's equity, net income, date of financial statement, type of asset impaired, amount of impairment before tax effects, where the disclosure is made, and

how the impairment was handled in the financial statements. From this data, conclusions will be drawn on total assets, shareholder's equity, net income, and the amount of the impairment based on all of the 328 statements. With that data, the amount of the write-off was compared to total assets, shareholder's equity, and net income.

Also, the number of companies whose income was driven negative because the Statement and the number of companies that applied the Statement earlier then required by the Statement were examined. By looking at the number of companies that fell under each of those two categories, the correlation between the amount of the write-off and whether the company disclosed early and the correlation between the income being driven negative by the write-off and whether the company was an early discloser was calculated. Next, the types of assets that were written off and how many firms under each SIC category was computed. Our results are presented below with detail about how this relates to financial reporting and then it will be analyzed as to any thoughts that might relate to such findings.

Before looking at the results, there are a few factors that may have skewed the results. A factor that pulled the results up is the fact that all companies with immaterial amounts were disregarded. This does not represent a true sample of all impairments, but rather a sample of impairments that were material to financial statements. Materiality is a concern since each company will tend to judge materiality based on their own standards. Companies with lower net income tend to have lower materiality levels, and companies with higher net income tend to have higher materiality levels. For instance, Pepsi Co. had an impairment loss of $384 million after-tax, but when compared to what they considered material, the impairment loss was not material. Pepsi's loss was higher than

that of what other companies listed as material. Unless it was material, companies did not have to and thus tended not to disclose it, and that is why the research did not include impairments unless it was material.

Along the same thought, but regarding discounted cash flows, pretend there are two companies with the exact same assets with the exact same book values, yet both of the book values are over valued. Company A is well managed, highly profitable and cash generative, while Company B struggles to break-even. In this situation, Company B will be triggered to recognize an impairment loss, while Company A will not. For the next issue, some companies have not yet recognized their impairments as of the time I did the research. Although many of these companies are adopting late, some of these still plan to have a material impairment loss. And lastly, some companies have policies similar to SFAS 121 and had recorded impairments as they have incurred them, and some companies felt that if SFAS was instated in prior years, it would have made some immaterial impairments material and other material impairments immaterial. It is situations like these that may have skewed the results.

Results

First we need to recognize how small the actual population of material impairments is. Out of the 3708 financial statements that were able to be used (3380 immaterial statements added to the number of statements used for statistical purposes), the 328 firms represent only 0.088% of companies that were even affected. So when looking at these results, one needs to keep in mind that this data only relates to the material statements, which is not a full representation of the whole population. However,

this research focuses on impairments according to 121, and this is a great representation of those companies who recorded impairments

As for most of the results, they can be found in the tables following the thesis. Total assets, shareholder's equity, and net income were compared to the write-off amount. The mean write-off amount was $156,570,649. The maximum write-off amount was over $29 billion, which seems outrageous that a company actually had $29 billion of impaired assets on their books. As might be expected, consideration needs to be taken for the fact that the $29 billion may have increased the following mean values. The median write-off amount was $9,300,000.

The mean percentages of the write-off amount compared to total assets was 7.75%, compared to shareholder's equity was 14.02%, and compared to net income was 43.40%. For instance, this means the 7.75% of assets were written off, 14.02% of stockholder's equity was reduced, and 43.40% of net income was reduced because of the impairment. One possible reason the net income percentage was so high was perhaps because some of the companies were already suffering and future cash flows were not high enough to support having these assets on their books, thus their net income was driven negative because of the impairment loss. Out of the 328 companies examined, 69 had income that was driven negative because of SFAS 121, which is about 21%. The correlation between that of the income that was driven negative by the write-off and whether it was disclosed early was a positive 0.047. The positive number means that the firm's income driven negative by the write-off was more likely to disclose early. Although many companies' income was driven negative, this charge had no impact on

cash flows, but had a significant impact on reported fourth-quarter profits for many of these companies.

Interestingly, the number of companies that disclosed early was 214 out of 328, which is about 65% that adopted before December 15, 1996. The correlation between the amount of the write-off and whether it was an early disclosure was a negative 0.087. The negative number means that the bigger the write-offs, the less likely they would disclose early.

Although there is a table showing the numbers of types of assets actually impaired the two main categories were about 28% property, plant, and equipment and 20% goodwill. Oil and gas properties counted for about 9% of total types of assets. The 105 long-lived assets was a category used when the type of asset was not disclosed or the company used the term long-lived assets. It seems interesting that 32% of the companies did not name the actual type of asset or group of assets.

Instead of looking at the types of assets impaired, it is now time to look at the types of companies that were required to make these charges. Among the hardest hit by the rule were the oil companies, because 121 requires that assessment be made at the lowest level at which cash flows can be separately identified. Most oil companies valued assets such as oil fields on a country-by-country basis, a system in which a profitable field would balance less profitable ones. Since 121 requires assets to be grouped at the lowest level, which would be oilfield-by-oilfield, a profitable field can no longer balance less profitable ones. From my sample, the percentage of oil companies in this category was about 11%. Other industries included eating and drinking places at 9%, business services at 6%, electric, gas, and sanitary services at 5%.

Conclusion

In looking at the overview of all the research, it shows how SFAS 121 has affected financial reporting. First, the FASB was able to create more consistency among firms, which was their underlying purpose. By creating this consistency, a large percentage of assets were written off, creating a reduction in net income for the year of implementation. Some of the companies' incomes were even driven negative.

It was found that property, plant, and equipment and goodwill was the most likely to be over valued, while oil companies and restaurants were the hardest hit industries. When FASB tried to create more consistency among firms, it did so by hitting similar types of assets and industries. This does not mean that those industries had the most to hide, but rather it was the way firms were operated in a particular industry. Each firm within an industry tries to be comparable with others within the same industry. Not only did FASB create greater consistency among all firms; FASB created a greater comparability among all firms.

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Tables

Table 1
The Computation of the Sample Size

The original number of statements was computed by using the data base Compact Disclosure. The words used for the search was a) "No. 121", b) "Long-lived assets", c) "Impairment" within three words of "assets".	4010
The number of statements which state their impairment amount was immaterial	-3380
The number of statements with not enough information such as no dollar amount or no date.	-223
The number of impairments found preceding or following initial adoption date	-52
The number of statements not related to SFAS 121	-27
The number of statements used for statistical purposes	**328**

Table 2
Total Assets of Sample Firms

Mean	$1,988,173,543
Minimum	$239,000
First Quartile	$74,630,250
Median	$253,903,500
Third Quartile	$1,091,405,000
Maximum	$42,138,000,000

Table 3
Shareholder's Equity of Sample Firms

Mean	$561,654,149
Minimum	-$1,274,900,00
First Quartile	$10,041,750
Median	$66,691,000
Third Quartile	$363,012,500
Maximum	$17,951,000,000

Table 4
Net Income of Sample Firms

Mean	$16,838,966
Minimum	-$695,100,000
First Quartile	-$22,204,000
Median	-$2,321,000
Third Quartile	$9,304,250
Maximum	$2,376,000,000

Table 5
Write-off Amount of Sample Firms

Mean	$156,570,649
Minimum	$27,228
First Quartile	$1,875,000
Median	$9,300,000
Third Quartile	$34,100,000
Maximum	$29,139,000,000

Table 6
Percentage of Write-off Amount Compared to Total Assets of Sample Firms

Mean	7.75%
Minimum	0.00%
First Quartile	1.19%
Median	3.30%
Third Quartile	8.38%
Maximum	93.62%

Table 7
Percentage of Write-off Compared to Shareholder's Equity of Sample Firms

Mean	14.02%
Minimum	-723.23%
First Quartile	2.33%
Median	7.20%
Third Quartile	18.91%
Maximum	761.81%

Table 8
Percentage of Write-off as Compared to Net Income of Sample Firms

Mean	43.40%
Minimum	-39100.00%
First Quartile	20.22%
Median	17.05%
Third Quartile	81.36%
Maximum	18,687.23%

Table 9
Asset Type Frequency of Sample Firms

Type of Asset	**# of companies**
Goodwill	65
Long-lived Assets*	105
Oil & Gas Properties	28
Property, Plant, & Equipment	93
Discontinued Operations	8
Capitalized Software Costs	7
Inventory	6
Patent & Trademarks	2
Leasehold Improvements	7
Services	1
Investments	5
Severance & Retirements	1

*Term used when type of asset was not disclosed.

Table 10
SIC Code Frequency of Sample Firms

Industries with more than 10 companies recording an impairment charge based on sample size of 328.

Type of Company	**# of companies**
Oil and Gas Extraction	36
Eating and Drinking Places	31
Business Services	21
Electric, Gas, and Sanitary Services	17
Petroleum Refining and Related Services	13
Machinery, except electrical	12
Electric and Electronic Machinery, Equipment, and Supplies	12
Health Services	12