

## Impairment of Goodwill in the Construction Industry

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The impairment of goodwill implemented by Statement of Financial Accounting Standard 142 (SFAS 142) is somewhat confusing and difficult to understand. Beginning with fiscal years ending after December 15, 2001, the new rules for the impairment of goodwill are to be adopted by all companies with goodwill on their balance sheets. Instead of amortizing goodwill on a straight line basis over a determined period of time (not to exceed 40 years), now companies must conduct an annual impairment test, or sooner if certain “triggering events” occur, based on the fair value of the reporting unit using a two-step process. Step one is to identify if goodwill has been impaired and step two is to measure the amount of impairment, as follows:

1. Compare the fair value of the reporting unit to its carrying value amount, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill is not impaired and the company does not need to record an impairment. If the fair value of the reporting unit is less than its carrying amount, then impairment has occurred and Step 2 is necessary to measure the amount of impairment loss, if any.
2. Compare the implied fair value of the reporting unit’s goodwill with the carrying amount of goodwill. If the carrying amount of the reporting unit’s goodwill exceeds the implied fair value of goodwill, an impairment loss shall be recognized in an amount equal to the excess. Obviously, the loss recognized cannot exceed the carrying amount of the goodwill. After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill shall be its new accounting basis. ***Subsequent reversal of a previously recognized goodwill impairment loss is prohibited. Also, a reporting unit may not record an increase to goodwill.***

The implied fair value of goodwill shall be determined in the same manner as the amount of goodwill recognized in a business combination (SFAS 141). That is, an entity shall allocate the value of the reporting unit to all of the assets and liabilities of that unit as if the reporting unit had been acquired in a business combination and the fair value price had been paid to acquire the reporting unit. The excess of the fair value over the amounts assigned to the assets and liabilities is the implied fair value of goodwill.

The idea behind this two-step process is that goodwill has an indefinite life and therefore cannot be reduced over a specified period of time. Instead, the fair value of the reporting unit must be evaluated each year to calculate if goodwill has been impaired. This can become a very expensive project over time since the second step will need to be performed by qualified business appraisers.

As stated previously, the test for impairment is to be performed on an annual basis or sooner if a “triggering event” should take place. The types of triggering events a construction company would be concerned with are:

- Loss of key personnel –the most important impairment value. Construction companies are service providers, which means their key management personnel make up the highest percentage of the goodwill being acquired. Loss of these key management people (their management style, estimating and bidding expertise, cultivated connections and experience) is the biggest impairment to goodwill, especially if only a few individuals make up the key personnel.
- Significant change in the business climate – most fair value calculations try to anticipate the economy and business climate into the future. Any negative downturn, similar to the difference between the construction industry in the 1990s and today, will negatively affect the fair value as the returns on equity and assets decrease.
- Unanticipated competition – If a major competitor from another economic region enters your market or key employees of your company, or another competitor, leave to open their own company, competition will increase for the limited availability of work. In better economic times there also seems to be more people entering the construction arena and bidding lower just to get the work. All these factors will have a negative impact on the reporting unit’s fair value. An example of unanticipated competition: If the company you purchased has the only asphalt plant in a certain territory, the asphalt plant is very valuable; however, if two competitors come into the territory, the asphalt plant you purchased now has real competition. The plant’s production use will decrease, competitive pricing will erode your gross profit on the plant, employees may leave to work for the competition, etc. The value of the asphalt plant will decrease significantly as will the reporting unit’s value.
- Losing a major general contractor/owner – whenever a company is purchased, new management or requirements from the new owners will change the management philosophy. This leads to changes in the relationships created by the previous management team with their subcontractors (or general contractors) that will affect future contract volume.
- Not meeting budgeted forecasts – in computing a fair value, future forecasts play a significant role. The construction industry’s mentality of awarding contracts based on the lowest bid leads to an unpredictable and volatile profit environment. When contractors encounter a few years of

low gross profits or net income, the fair value of the company is sure to be affected. If the contractor is no longer performing based on the valuation model (experiencing job fade or reduced gross profit margins), then the model must be reassessed and a new fair value computed (most likely a fair value that has decreased).

- Change in the Company's name – a name change brings about confusion and questions from contractors doing business with the former company and from competitors of the former company. Any uneasy feeling created in the marketplace about a construction company will erode its market presence. Will management change next? Will business be conducted at the same level of quality? Who are the new owners? All these questions will be answered over time, but in the short run the company's value will be reduced. A decrease in revenue volume or gross profit will be evidence of this impairment.
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of – notice that a reporting unit may be disposed will have a negative impact on the fair value computation.
- An adverse action or assessment by a regulator – these situations will affect the valuation model based on the severity of the assessment. If a major claim against the construction company is awarded outside of the insurance limits, the company will have to absorb the loss. If a contractor experiences a reduction in bonding or licensing capacity, the fair value could be significantly impaired. These adverse assessments could have a large impact on the fair value of the company.

Any one of the events mentioned above can occur in the construction industry in any year. With the high risk of the construction industry, low bidder mentality, high competition rate, and unpredictable future, it is the authors' opinion that a reasonable benchmark for the impairment of goodwill is generally no more than fifteen years. Our basis behind this statement is:

- Key management personnel will not have the same incentive to work as hard to be profitable, especially those who owned stock in the previous company. They have received money (and sometimes stock) for their business and thus have less incentive to work to build value in the company that is no longer theirs.
- The companies being purchased are looking for shareholder exit strategies and therefore the key employees will not be with the new company for a long period of time.
- Job fade on contracts purchased usually will be identifiable in the first few years after the acquisition. This may result in a large adjustment to the fair value of the company since the valuation model will need to be adjusted to include the contract fade.
- The surety industry sees no value in intangible assets and will reduce equity for the amount of intangible assets indicated on the balance sheet;

- therefore, there is no incentive for construction companies to keep goodwill on the books any longer than required by GAAP.
- The customer base will change drastically over a fifteen-year period. Thus the original customer base purchased will no longer have value.

Based on all we have noted, the implied fair value computation for goodwill is based on an appraisal by someone who must understand the construction industry and can properly value the purchase price and net assets (i.e. your CPA). In addition, it is extremely important that the initial allocation of fair value to the net assets be performed in accordance with SFAS 141. Any identifiable intangible assets (non-compete agreements, contracts, etc.) that can be recognized will decrease the residual value assigned to goodwill, thus lowering the value of goodwill subject to the impairment testing of SFAS 142.

The Construction Industry has the second highest failure rate in the United States, is extremely sensitive to economic conditions, and in good economic times must rely heavily on the management personnel and relationships to be consistently profitable. In addition, banks and surety companies do not recognize goodwill as an asset, but rather as a deduction to equity. These negatives all lead to an eventual impairment of goodwill over a shorter duration than other industries, especially when key management personnel leave.