Implementing the impairment of assets requirements of SFAS No. 144
An empirical analysis

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Abstract The provisions of Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-lived Assets, have raised many implementation issues for entities adhering to its increased requirements to recognize and measure the costs associated with the impairment of assets. After outlining these new requirements and some general implementation issues, the paper discusses how members of key groups view the new standard, using the responses to a mail survey. It was found that user-oriented groups expressed significantly different viewpoints than did preparer-oriented groups. The survey results also found many respondents stating that the new standard provides improved guidance for many complex situations, while others do not believe that the standard is cost justified.

In 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-lived Assets (FASB, 2001). Superseding the provisions of SFAS No. 121, Accounting for Long Lived Assets and for Long Lived Assets to be Disposed of, SFAS No. 144 affects the measurement of all long-lived assets held for use or future disposal, including lessees’ capital leases, lessors’ assets subject to operating leases, long-term prepaid assets and amortizable intangibles. Its provisions also affect such other assets and liabilities as accounts receivable and inventory. SFAS No. 144 defines an asset group as the lowest level whose identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities, e.g. a specific production process. Similarly, a disposal group represents a set of long-lived assets expected to be disposed of by sale or otherwise, focusing on assets and liabilities forming part of a single transaction.

SFAS No. 144 does not apply to goodwill, indefinite life intangible assets, financial instruments (including investments in equity securities accounted for under the cost or equity method), deferred policy acquisition costs or deferred tax assets. However, while the scope of SFAS 144 excludes the impairment of goodwill or other intangible assets, SFAS No. 142, Goodwill and Other Intangible Assets, issued in 2001, addresses the impairment of goodwill and non-amortized intangible assets.
SFAS No. 144 classifies long-lived assets into three distinctive categories:
(1) Held and used.
(2) Disposed of other than by sale.
(3) Disposed of by sale.

Long-lived assets to be held and used
Impaired long-lived assets often produce major losses to holders of such assets. A long-lived asset becomes impaired when an individual long-lived asset’s (or asset group’s) carrying amount exceeds its fair value. Such holders should recognize and measure impairment losses to determine potentially impaired long-lived by:
   • considering whether impairment indicators (discussed later) arise;
   • testing long-lived assets for recoverability when certain impairment indicators arise; and
   • recognizing an asset impairment loss only after assessing if the carrying amount of a long-lived asset is not recoverable and exceeds its fair value.

Recognition and measurement
Under SFAS No. 144, an asset’s carrying amount is not considered recoverable if its carrying amount exceeds the sum of the undiscounted cash flows expected to result from the asset’s use and ultimate disposal, regardless if the asset is in actual use or development. Impairment loss equals the excess of the asset’s carrying amount over its fair value.

Impairment indicators – when to test
Firms should test long-lived assets for recoverability when events indicate that carrying amounts may not be recoverable, such as significant:
   • decreases in the market price of a long-lived asset (asset group);
   • changes in the extent or manner that assets are used;
   • physical changes to the asset;
   • adverse changes in legal factors or business climate that could affect the assets’ values or a regulator’s adverse actions or assessments;
   • cost accumulations exceeding the amount originally expected to acquire or construct the assets;
   • current period operating or cash flow losses combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with an asset; and
   • these provisions anticipate that the firm will more likely than not (i.e. greater than 50 percent probability) dispose of this asset before the end of its previously estimated remaining useful life.

Grouping assets
Firms should group long-lived assets tested for impairment with other assets and liabilities for which the lowest level of identifiable cash flows are largely independent of other assets and liabilities’ cash flows. Asset groups including an entire reporting unit should include goodwill in the asset group tested for impairment. However, firms
should exclude goodwill from such an asset group if it is only part of a reporting unit. Firms testing impairment on a long-lived asset within an asset group should adjust the carrying amount of other assets within the group that are not subject to SFAS No. 144’s requirements (e.g. provide an allowance for doubtful accounts and adjust inventory to its net realizable value).

Cash flow estimates
SFAS No. 121 considers only expected future cash inflows less associated (i.e. directly related) cash outflows (excluding interest charges) expected to occur from using and disposing of the asset (group). SFAS No. 144 provides additional guidance to implement the above basic requirement, focusing on:

- the estimation approach;
- the estimation period; and
- types of asset-related expenditures to consider.

The estimation approach
Firms should use reasonable assumptions to estimate their own use of assets, consistent with other information for similar periods. But firms contemplating alternative plans or estimated ranges of possible outcomes should consider the likelihood of those possible outcomes.

The estimation period
Firms should use appropriate estimation periods to determine their assets’ estimated future cash flows and remaining estimated useful lives over the period that they expect to receive service potential (i.e. the remaining useful life to the entity) from the long-lived asset (s). For long-lived assets that are part of an asset group, the cash flow estimation period is the remaining useful life of the primary asset of the group. Indefinite-lived assets, such as land and intangible assets not being amortized, are ineligible to be the primary assets of the group.

Example. XYZ Company tests its long-lived asset group for recoverability purposes. It first decides that machinery is a production group’s primary asset, since this high-tech hydraulic equipment critically builds the group’s capacity to generate cash flows, although its carrying value is not the largest in the group. The machinery also meets other tests that identify it as the primary asset, especially considering that without the machinery, production would cease and XYZ could not produce other assets. The machinery has an eight-year useful life, while other assets in the group have useful lives of six years, 11 years and 12 years. XYZ then ascertains that for purposes of testing recoverability, future cash flows of the asset group should be projected over the life of this critical machinery: eight years.

Allocating impairment loss
SFAS No. 144 indicates that any impairment loss to a long-lived asset or an asset group reduces only the carrying amounts of that asset or group. The loss will be allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets. However, the loss allocated to an individual long-lived asset of the group will not reduce the carrying amount of that asset below its fair value. If an impairment loss is recognized, the adjusted carrying amount of a long-lived asset will be its new cost basis. For a depreciable long-lived asset, the new cost basis will be
depreciated (amortized) over the remaining useful life of that asset. Restoration of a previously recognized impairment loss is prohibited.

Example. GCS Company owns a manufacturing facility that, along with other assets, it tests for recoverability as a group. The asset group also includes accounts receivable, inventory (reported at the lower of cost or market) and other current assets and liabilities not covered by SFAS No. 144. The $3.1 million aggregate carrying amount of the asset group is not recoverable and exceeds its fair value by $700,000. Thus, CGS allocates the $700,000 impairment loss to the long-lived assets of the group (Table I).

Asset-related expenditures

Development substantially complete. Firms with a substantially complete asset should estimate future cash flows based on that asset’s existing service potential at the dates of impairment, considering the asset’s remaining useful life, cash-flow-generating capacity and physical output capacity. They should consider future cash outflows needed to maintain the long-lived asset’s existing service potential (e.g. repairing an existing laser saw machine), but not future capital expenditures that would increase the asset’s service potential (e.g. adding a new laser saw to the machine in order to expand its productive capacity).

Asset under development. Firms should include cash flows related to all future expenditures to substantially complete the asset to measure the recoverability of long-lived assets under development, such as capitalizable interest payments under SFAS No. 34.

Comparing estimated cash flows to carrying amount

After estimating future cash flows to test recoverability, if the asset’s carrying amount exceeds the sum of the estimated future cash flows, a recognized impairment loss arises equal to the amount that the carrying amount of the asset exceeds its fair value.

Fair value and new cost basis

SFAS No. 144 sets an asset’s fair value as the amount that the firm could buy or sell it in a current single transaction between willing parties (i.e. other than in a forced or

<table>
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<th>Asset group</th>
<th>Carrying amount ($)</th>
<th>Pro-rata allocation factor</th>
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<td>Total</td>
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Note: Also include any goodwill as part of the asset group tested for impairment because it is a reporting unit

Table I.
Reporting and disclosure

Impairment losses should be presented within income from continuing operations before income taxes. The notes to the financial statements should include:

- description of impaired long-lived asset (group) and circumstances leading to the impairment;
- amount of impairment loss and caption in the statement of income that includes the loss, if not presented separately on the face of the statement;
- method(s) to determine fair value; and
- segment in which the impaired long-lived asset (asset group) is reported, if applicable.

Long-lived assets to be disposed of other than by sale

Firms should continue to classify a long-lived asset or an asset group as held and used until they plan to dispose of it by:

- abandonment;
- exchange for similar productive long-lived assets, or
- distribution to owners in a spin-off.

They should classify swapped or spun off long-lived assets as held for use until the transaction occurs. At the transaction date, they should recognize impairments for the excess of the carrying amount over fair value, and classify abandoned assets as held for use until they stop using them. Abandoned or spun off groups of long-term assets also become part of discontinued operations at the disposition date.

Example. On 1 July 2002, Y Company planned to abandon on 30 June 2003 a special type of drill press used for operations owing to a decrease in business. Y purchased this drill press ten years ago for $200,000, estimated its useful life at 15 years and salvage value at $5,000. This abandonment decision has cut the asset’s remaining useful life from five years to one year, and the company will use APB Opinion 20 to account for this change. Thus, on 1 July 2002, the drill press’ carrying value of $67,000 will be depreciated over the next year, making estimated salvage value as $5,000 on 30 June 2003, the date of abandonment. However, since the early abandonment decision is considered an impairment indicator, Y Company should perform a recoverability test on July 1, 2002 to determine if the $67,000 is recoverable over the next year. Since the $5,000 salvage value is nominal, the drill press is not subject to Statement No. 144’s “held for sale” provisions. If the recoverability test shows that the asset’s fair value is not recoverable (measured by the estimated undiscounted cash flows of only $8,000), the fair value of the drill press should be determined. Thus, an impairment charge of $59,000 ([$67,000 less $8,000]) should be recorded on 1 July 2002 and $3,000 should be recorded as depreciation expense (the new carrying amount of $8,000 less salvage value of $5,000) over the next year. However, no impairment loss should be recorded if the drill press’ carrying value had been recoverable.
Long-lived assets to be disposed of by sale

Recognition
Not requiring a binding agreement for future sale, a long-lived asset or disposal group cannot be considered held for sale unless it meets all of the following criteria:

• management, with the authority to approve the action, commits to a plan to sell the asset;
• the asset is available for immediate sale in its present condition, subject only to usual and customary terms for sale of such assets;
• it actively markets the asset for sale at a reasonable price relative to its current fair value;
• it actively seeks to locate buyers and takes other actions to sell the asset; and
• significant changes to the plan seem unlikely, lest the firm will withdraw that plan.

Related costs to sell include incremental direct transaction costs, but not future operating losses. Firms no longer meeting such criteria should reclassify the long-lived assets as held and used.

Newly acquired assets
Firms should classify a newly acquired long-lived asset that they plan to sell as held for sale at the acquisition date only if:

• at the acquisition date, the firm meets the one-year requirement to transfer the asset; and
• any other held-for-sale condition of SFAS No. 144 that the firm does not meet as of the acquisition date can probably be met within three months after the acquisition date.

Measurement
On meeting the criteria to classify a long-lived asset as held for sale, firms should measure the asset at the lower of its carrying amount or fair value less cost to sell and cease depreciation or amortization. Related costs to sell include incremental direct transaction costs but not future operating costs. Newly acquired assets’ carrying amounts should be based on their fair value less cost to sell at the acquisition date.

Prior to measuring the fair value less cost to sell of a disposal group, a firm should adjust the carrying amount of any assets that SFAS No. 144 does not cover, including goodwill and continue to accrue interest and other costs associated with the liabilities of a disposal group.

Asset costs include such incremental direct selling costs as broker commissions, legal and title transfer fees and closing costs, but not accrued future operating losses. Firms should recognize losses for initial or subsequent write-downs to fair value less selling costs, and recognize gains for subsequent increases in the asset’s fair value less selling costs, limited to cumulative losses previously reported. On the actual sale of the asset, firms should recognize all gains and losses not previously recognized.
Reporting long-lived assets and disposal groups to be disposed of

Reporting discontinued operations

SFAS No. 144 significantly changes the requirements to report discontinued operations, focusing on the concept of an entity’s components and on its discontinued operations. Such components comprise operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the firm. Thus, it could be:

- a reportable segment or an operating segment;
- a reporting unit;
- a subsidiary; or
- an asset group, which facilitates classifying asset sales or disposals as part of discontinued operations.

Meeting the discontinued operations definition for a firm component or segment that a firm has disposed of or classified as held for sale requires two conditions:

1. Operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the firm as a result of the disposal transaction.
2. There will be no significant continuing involvement in the operations of the component after the disposal transaction.

Rather than accruing them as future operating losses, firms meeting these conditions should report all gains and losses resulting from changes in the component’s carrying amounts, less applicable income taxes (benefit), in discontinued operations as a separate part of income before extraordinary items and the cumulative effect of accounting changes (if applicable).

Balance sheet presentation of long-lived assets classified as held for sale

Long-lived assets classified as held for sale should be presented separately in the balance sheet. Firms may not present the net carrying amount of the disposal group as a single line item. Major classes of assets and liabilities classified as held for sale should be disclosed separately on the face of the balance sheet or in the notes to the financial statements.

Disclosure

For long-lived assets or a disposal group classified as held for sale or sold during the period, firms should disclose in the notes to its financial statements:

- Description of facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not presented on the face of the balance sheet, the major classes of assets and liabilities included as part of a disposal group.
- The method for determining fair value.
- The segment in which the long-lived asset (disposal group) is reported under SFAS No. 131.

Firms should also disclose its components that comprise operations and cash flows that can clearly be distinguished from the rest of the entity operationally and for financial reporting purposes. Such components may be reportable or operating
segments (as defined in SFAS 131), reporting units (as defined in SFAS No. 142), or asset groups (as defined in SFAS 144).

The provisions of SFAS No. 144 provide useful tools for disclosing more fully their operations all entities that acquire, use and dispose of capital assets. All types of businesses should plan to adopt these provisions.

Empirical study

Methodology

To explore how key constituencies view SFAS No. 144, we surveyed four major groups with vested interests in these issues:

1. CPAs specializing in auditing publicly-traded institutions.
2. Internal auditors (IA) using the Institute of Internal Auditors Membership List.
3. Management accountants (MA) selected from the Institute of Management Accountants Membership List.

We sent the 400 questionnaires to 100 members from each group.

After reviewing the current literature for impairment we developed a preliminary survey instrument, which we then pretested and revised based on the comments of six academicians, five CPAs, six internal auditors and five management accountants. The survey instrument addressed three main areas of impairment – statements relating to:

1. the concept of impairment;
2. impairment factors;
3. the value of SFAS No. 144 to improved financial reporting.

We sought to ascertain and analyze different users’ opinions about how well SFAS No. 144 addressed asset impairment financial needs. The final questionnaire appears next.

Survey statements asked

1. Asset groups (including an entire reporting unit) should include goodwill in testing for impairment.
2. Implementing the grouping of assets and the determining of cash flow should focus on:
   • the estimation approach;
   • the estimation period; and
   • types of asset-related expenditures to consider.
3. The following impairment factors should determine when to measure impairment:
   • a significant decrease in the market price of a long-lived asset (asset group);
   • a significant change in the extent or manner in which a long-lived asset (asset group) is being used;
• a significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator;
• an accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group);
• a current-period operating or cash flow loss combined with a history of operating or cash flow losses associated with the use of a long-lived asset (asset group); and
• a current expectation that it is more likely than not (greater than 50 percent) that a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

(4) Impairment should not consider future capital expenditures that would increase a long-lived asset’s service potential when the asset’s development is substantially complete.

(5) Impairment of assets should focus on the concept of an entity’s component (e.g. a reportable segment, a reporting unit, a subsidiary, or an asset group) rather than on an entity’s operating segment.

(6) Undiscounted cash flows better measure potential impairment than does the present value of cash flows.

(7) SFAS No. 144 improves financial reporting compared to its predecessor, SFAS No. 121.

The overall benefits of SFAS No. 144 will justify the costs of implementation.

To garner a high response rate, we hand-signed all correspondence, used four waves of response requests (including pre-notification letters), and applied postage stamps on envelopes both to and from the respondents. We received 120 usable responses (i.e. from 36 CPAs, 29 from IAs, 31 MAs and 24 FAs), an overall 30 percent response rate. Even with a relatively high response rate, we tested for non-response bias using Oppenheim’s (1966) early-late hypothesis, and Ferber’s (1948) comparison of known characteristics of respondents and non-respondents. The results indicate no significant \( p \leq 0.05 \) differences between early and late respondents, suggesting strongly that no significant non-response bias occurred.

We asked respondents unfamiliar with SFAS No. 144’s provisions to return the survey instrument anyway and mark its provisions “unfamiliar,” receiving such responses from 12 CPAs, 14 internal auditors, nine management accountants and 27 financial analysts. The respondents used a seven-point Likert scale (7 indicating agreement and 1 disagreement) to denote their degree of agreement or disagreement to statements addressing the key issues. While these statements ordinarily suggest “yes” or “no” answers, the Likert scale allows a continuum of strongly agree to strongly disagree responses. Table II summarizes the respondents’ input.

Where the ANOVA denoted significant differences \( p < 0.05 \) among the four groups of respondents’ mean responses, we used Scheffe’s multiple comparison test to determine which groups had statistically significant differences. A summary of such results appears in Table III.
Results and observations
The results show significant differences among the four groups of respondents. Financial analysts were more likely to disagree with other respondents, probably since they are the most user-oriented group of respondents.

Financial analysts’ responses differ significantly from the other three groups regarding Statements 1, 2B, 3B and 3F. Statement 1 (CPAs: 6.12; IAs: 5.45; MAs: 5.47; and FAs: 4.75) focused on whether asset groups should include goodwill in the asset groups in testing for impairment as required by SFAS No. 144. Perhaps they believe that SFAS No. 142 addresses adequately the separate test for the impairment of goodwill, or that including goodwill in the asset group would compromise the test results for the tested asset group. The other three groups might want to include goodwill because it would give a higher cash flow and therefore the possibility of a write-down would be less likely.

Similarly, in Statement 2B (CPAs: 5.57; IAs: 5.27; MAs: 5.81; and FAs: 4.82) financial analysts believe that the “estimation period” is the least important element to focus on when implementing the grouping of assets and the determining the cash flow. This is probably just a matter of relevancy.

Statement 3 examined the importance of various factors to determine when to measure impairment. Financial analysts in Statement 3B (CPAs: 5.35; IAs: 5.16; MAs: 5.05; and FAs: 4.41) did not believe as strongly as the other three groups that change in the use of an asset was as important as some of the other factors. In Statement 3F (CPAs: 3.65; IAs: 3.35; MAs: 3.62; and FAs: 2.54), FAs were not as concerned when it was likely that...
an asset was being sold before the end of its previous estimated life. This difference could be owing to the FA’s greater overall interest on cash flow versus specific asset groups. Relative to the other factors, they do not believe that these factors would be as significant for doing tests on specific asset groups.

In Statement 6 (CPAs: 4.36; IAs: 4.78; MAs: 5.78; FAs: 3.23), MAs disagreed with the other three groups over the use of “undiscounted cash flow”. Management accountants want to use it versus “discounted cash flow”, perhaps because it would be less likely that an asset or asset group would have to be written down. Their approach is more from a preparation than a user perspective. On the other hand, FAs are users of the financial information and prefer a more conservative approach used. Discounted cash flows would indicate asset impairment and measurement sooner in many cases.

Management accountants agreed significantly more with Q4 (CPAs: 2.42; IAs: 2.25; MAs: 3.10; and FAs: 2.24). They do not want to consider future capital expenditures that would increase a long-lived asset’s service potential when the asset’s development is substantially complete. More capital expenditures would generate a higher cost, which could more likely make an asset impaired and thus incur more costs in writing down the asset. MAs were in less agreement on Q8 (CPAs: 5.25; IAs: 4.67; MAs: 3.98; and FAs: 5.37). They do not believe that the benefits of SFAS No. 144 outweigh the costs. Again, they are viewing the situation from a preparer’s point of view.

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<th>Table III. Scheffe pairwise comparison test results</th>
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Summary and conclusions
Our findings show that all respondent groups believe that SFAS No. 144 improves financial reporting as compared to its predecessor, SFAS No. 121. The respondent groups found acceptable most of the FASB’s suggestions to determine when to measure impairment. The respondents view favorably SFAS No. 144’s focus on the concept of an entity’s component rather than on an entity’s operating segment. Also, the respondents received well the focus elements of SFAS No. 144. However, the respondents were not pleased with, for example, the use of undiscounted versus discounted cash flow for the impairment test. Many respondents also questioned whether the benefits of SFAS No. 144 outweigh the costs. While costly and time-consuming to implement, SFAS 144 will increase the fairness of financial reporting. Firms can use this article to help them adopt its procedures as expeditiously as possible, or seek the counsel of outside experts as they better account for impaired or disposed long-lived assets.

References

Further reading