Goodwill Impairment in the Face of Calls for Change in Fair Value Treatment

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Companies today face a continuing whirlwind of changing standards, guidance, and practices when it comes to performing fair value analyses under both International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP). This paper highlights worldwide calls for change in financial reporting treatments, which have manifested themselves in newly issued Financial Accounting Standards Board (FASB) Accounting Standards Updates and Interpretations specific to FASB Accounting Standards Codification (ASC) No. 350, Intangibles - Goodwill and Other.

The Context of Change

Today, the global financial crisis continues to present a monumental opportunity for reflection on, and reform of, any deficiencies in the current financial reporting framework. Policymakers have addressed calls for change in order to enhance overall transparency between investors and investments, particularly in today’s marketplace rich in intangible capital.

In the U.S., FASB established the Private Company Council (PCC) in May of 2012 to determine whether exceptions or modifications to traditional U.S. GAAP are necessary in order to reduce the burden of compliance costs on private companies. Today, FASB is now contemplating extending certain private company accounting alternatives to public companies. It is noteworthy that these current deliberations adhere to FASB’s normal due process, whereby topics are added to its technical agenda based on the demand from constituents for improvements in financial reporting, rather than exceptions simply due to compliance costs.
Private company reporting requirements today provide a high degree of optionality, in that FASB and the PCC have leeway in identifying and approving certain private company accounting alternatives. Private companies themselves have the option to apply either private or public company standards. Furthermore, they also have the choice of applying some, but not all, of the private company reporting alternatives available to them.

The financial statements of both private and public companies will now be considered “in accordance with U.S. GAAP,” and memorialized as such in outside audit opinions. However, footnote disclosure differences are likely only to provide a qualitative description of options taken, without any differential quantification of effects, since no such quantification is required.

Current policymaker efforts to stimulate long-term investments as one component of economic regeneration are laudable. However, one contentious issue highlighted in the 2013 European Commission Green Paper on long-term investing in Europe is whether fair value accounting requirements have been misleading investors who rely on a detailed review of financial statements.

**International Consequences for Companies and Investors**

Companies reporting under U.S. GAAP and International Accounting Standards (IAS) have to deal with goodwill impairment testing complexities and nuances under each body. IAS 36, *Impairment of Assets*, requires an entity to test goodwill for impairment using a single-step quantitative test performed at the level of a cash generating unit or group of cash generating units. Differences between U.S. GAAP and IAS create inconsistencies as to whether goodwill is impaired, and if so, how much is impaired. Furthermore, technical approaches vary between U.S. GAAP and international financial reporting standards under IAS.

IAS 36 requires an entity to compare the carrying amount of a cash generating unit with its recoverable amount. An entity would record the excess of the carrying amount over the recoverable amount as an impairment loss, and the amount of the impairment loss is not limited to the carrying amount of goodwill on record in the cash-generating unit. This stands in stark contrast to the traditional two-step goodwill impairment test performed under U.S. GAAP, which limits goodwill impairment to the carrying value of goodwill at the “reporting unit” level, which is defined as an operating segment or one level below such segment.

Additionally, under IAS 36, *small and medium-sized enterprises* (SMEs) are able to amortize goodwill over its estimated useful life or a 10-year period if a reliable estimate cannot be made. An SME reporting under IAS is required to make a qualitative assessment of whether there is any indication that goodwill may be impaired.

**Who Benefits – Back to First Principles**

The principal purpose of financial statements is to provide transparent information useful to investors in their capital investment and allocation decisions. The push for simpler standards is not being driven by investors, but rather by preparers of financial statements and their outside auditors. The creation
of separate standards for SMEs and private companies may result in a loss of comparability with the financial statements of public companies, which is vital to both equity and debt investors who invest in all types of companies. Moreover, the impact may be worse for U.S. investors since SMEs must state that their financial statements have been prepared “in accordance with” international financial reporting standards for SMEs. Private companies do not have a similar mandate, hence, the financial statements of both public and private companies in the U.S. – despite their differences – would still be considered in accordance with U.S. GAAP. This aspect contradicts the comparability issue and leaves it up to investors to discern the differences.

**Traditional U.S. GAAP Authority for Goodwill Impairment Testing**

Under U.S. GAAP, ASC 805 – *Business Combinations* provides guidance on the accounting for transactions characterized as business combinations under the acquisition method. Under the acquisition method, goodwill arises when total consideration exceeds the fair value of the net acquired assets, including real, personal, and intangible property. The corresponding goodwill amount is booked as an asset on a company’s balance sheet. ASC 805 defines goodwill as “an asset representing future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized.”

**Step One – Fair Value Calculation**

Goodwill is not amortizable for U.S. GAAP purposes, but is (at least) annually tested for impairment for each reporting unit of a business, and pursuant to ASC 350, is performed in two steps. The first step (“Step One”) compares the fair value of a reporting unit with its carrying amount; if the fair value is less than the carrying amount, then Step Two is performed to measure the amount of the impairment, if any. The two-step process for goodwill impairment testing under U.S. GAAP is illustrated in Figure 1 below.

![Figure 1](Houlihan Lokey)
However, under certain conditions, both public and private entities have the option to perform an alternative or precursor test to Step One, ostensibly based on less rigorous analysis. These options are discussed later in this paper while the traditional Step Two is discussed below.

**Step Two – Goodwill Impairment Calculation**

Should an entity fail Step One, the preparer must compare the fair value of goodwill to its carrying value to calculate the impairment loss. As indicated in ASC 350, “the fair value of goodwill can be measured as a residual and cannot be measured directly.” Accordingly, the implied fair value of goodwill should be determined in the same manner as the amount of goodwill recognized in a business combination under ASC 805. That is, an entity should assign the fair value of the reporting unit, as measured in Step One, to all underlying assets and liabilities of the reporting unit as if the reporting unit had been acquired in a business combination.

Step Two of the traditional impairment test requires a hypothetical application of the acquisition method to calculate the implied value of goodwill as a residual. Under this approach, an entity is required to value all material assets and liabilities, including tangible assets such as real property, personal property including machinery and equipment, and identifiable intangible property such as trademarks and customer lists, among other potential assets and liabilities. If the carrying amount of goodwill exceeds the resulting residual fair value of goodwill, an impairment loss equal to the excess is recognized. The Step Two process can be complex and costly for both public and private companies alike given the wide breadth of potential underlying assets and liabilities, particularly identifiable intangible assets.

A quantitative example of the overall two-step goodwill impairment test is shown in Figure 2 below, where reporting unit “A” has a fair value of 1,000 and a corresponding book value of 800. Since fair value exceeds book value, reporting unit “A” passes Step One and no further testing is required. In contrast, reporting unit “B” has a fair value of 500, or 100 less than its carrying value of 600. As a result, Step Two is necessary to calculate any potential goodwill impairment for reporting unit “B,” which requires a valuation of its underlying assets and liabilities in order to definitively determine if goodwill is impaired. In the example below, reporting unit “B” has goodwill with a fair value of 75, resulting from the allocation of its overall fair value of 500, to its underlying assets and liabilities. Assuming the book value of goodwill for reporting unit “B” is 200, a resulting impairment charge of 125 is indicated. While this amount is greater than the 100 of deficient reporting unit “B” fair value under Step One, a resulting impairment charge of 125 is recognized, given the fair value allocation of reporting unit “B” to the fair value of its underlying tangible and intangible assets acquired in a hypothetical business combination.
Historical Trends in Goodwill Impairment

By definition, under traditional U.S. GAAP as well as simplified standards for SMEs and/or private companies, any write-down of goodwill directly considers the fair value of companies and reporting units within them.

In 2008, U.S. declines in consumer spending, business investment, imports from its major trading parties, and overall GDP characterized the worst recession in recent history. The capital markets, and inherently fair value accounting, reflected these negative trends, which in part, escalated goodwill impairment to high levels in 2008, as shown below in Figure 3. The chart presents total goodwill impairment charges between 2007 and 2013 for public companies traded on U.S. exchanges, as well as the S&P index over the same period. In 2012, a spiked increase in goodwill impairment was driven primarily in the technology sector, where Hewlett-Packard, T-Mobile, and Microsoft recorded impairment charges of $18 billion, $8 billion, and $6 billion, respectively. In addition, General Motors Company recorded an impairment of $27 billion in 2012.

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**Example Goodwill Impairment Calculation:**

<table>
<thead>
<tr>
<th>STEP 1:</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Value of Reporting Unit</td>
<td>1,000</td>
<td>500</td>
</tr>
<tr>
<td>Book Value of Reporting Unit</td>
<td>800</td>
<td>600</td>
</tr>
<tr>
<td>Difference</td>
<td>200</td>
<td>(100)</td>
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</table>

<table>
<thead>
<tr>
<th>STEP 2:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Value of Reporting Unit</td>
<td>500</td>
</tr>
<tr>
<td>Fair Value of Reporting Unit’s tangible net assets</td>
<td>(225)</td>
</tr>
<tr>
<td>Fair Value of Reporting Unit’s intangible net assets</td>
<td>(200)</td>
</tr>
<tr>
<td>Implied Fair Value of Goodwill</td>
<td>75</td>
</tr>
<tr>
<td>Book Value of Reporting Unit’s Goodwill</td>
<td>(200)</td>
</tr>
<tr>
<td>Goodwill Impairment Loss</td>
<td>(125)</td>
</tr>
</tbody>
</table>
Simplifying Goodwill Impairment Testing Under U.S. GAAP and Understanding the Costs

Preparers and users of financial statements expressed concerns regarding the complexity and cost of performing a two-step goodwill impairment test. These concerns were addressed in accounting standard updates to ASC 350, which are addressed below.

Step Zero: A Step One Alternative

Even prior to the formation of the PCC in May 2012, preparers of financial statements expressed concerns to FASB surrounding the cost and complexity of requiring an annual Step One goodwill impairment test as required under ASC 350. Accordingly, in 2011, ASU 2011-08, Intangibles – Goodwill and Other (Topic 350) introduced an optional qualitative assessment (“Step Zero”) for testing goodwill for impairment.
Under Step Zero, entities are permitted to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described above. As such, a company is not required to fair value a reporting unit(s) under Step One of ASC 350 unless the company determines under Step Zero that it is more likely than not that the reporting unit’s carrying value exceeds its fair value. However, entities also have the option to forego Step Zero and perform a Step One test at the outset.

Step Zero: Process

In reaching a conclusion as to whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, an entity should assess relevant events and circumstances, including:

- Macroeconomic conditions – including deterioration in general economic conditions;
- Industry and market considerations – including deterioration in the environment in which an entity operates, a decline in market multiples, and a change in end market for products or services;
- Cost factors – including increases in raw materials and labor;
- Overall financial performance – such as negative or declining cash flows or a decline in projected results; and
- Reporting Unit changes – including a change in the carrying amount of net assets, a more-likely-than-not expectation of selling or disposing a portion of the reporting unit.

If after assessing the totality of events and circumstances such as those above, an entity determines that it is more likely than not that the fair value of a reporting unit is greater than its carrying amount, then neither Step One nor Step Two of the ASC 350 goodwill impairment test is further required. In conducting a qualitative assessment, a company may consider recent fair value indications for all reporting units, as well as the magnitude by which any reporting unit previously failed Step One.

Step Zero: In Practice

While the intent of Step Zero is to streamline and minimize annual goodwill impairment efforts, in actuality, the documentation and analysis by the preparer arguably comports to that required under Step One of ASC 350. In practice, a preparer must still document and support market data, such as comparable companies, long-term entity forecasts, historical financials, comparisons to prior forecasts, industry overviews, among other factors. Furthermore, should a Step Zero analysis indicate a more likely than not failure, an entity must also perform Step One, thereby increasing compliance efforts and costs. As a result, many entities simply exercise traditional GAAP, beginning with Step One.
Alternative Method: A Step One Alternative for Private Companies

One of the initial agenda items for the PCC was discussion regarding intangible assets and goodwill. The PCC reached out to current company stakeholders to solicit feedback for the initial recognition and subsequent measurement of intangible assets and goodwill acquired in business combinations. The PCC found that users of private company financials place limited importance and decision-useful information on the goodwill impairment test because most users simply disregard goodwill and goodwill impairment losses in their analyses of a private company’s financial condition. The PCC also received feedback from auditors of private company financial statements outlining their concerns about the cost and complexity in performing the goodwill impairment test. Based on this feedback, the PCC recommended to the FASB potential alternatives to the accounting framework.

Accordingly, in 2012, the FASB released ASU 2014-02 Intangibles – Goodwill and Other (Topic 350), which addresses the PCC’s concerns regarding the relevance, cost, and complexity of performing goodwill impairment analyses for private companies. The updates in the amendment apply to all entities, with the exception of public business entities and not-for-profits. The amendments allow for private companies to take an accounting alternative election for the subsequent measurement of goodwill (the “Alternative Method”). Private companies electing the alternative would amortize goodwill on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates another useful life is more appropriate.

Alternative Method: When to Test

The Alternative Method also simplifies the goodwill impairment test and eliminates the need for private companies to assess the fair value of goodwill on at least an annual recurring basis, as previously mandated under ASC 350. A private company that elects to amortize goodwill will now be required to perform a goodwill impairment test only when a triggering event indicates that the fair value of the reporting unit may be less than its carrying amount. As a result, upon a triggering event, a private company has the option to assess qualitative factors to determine whether a quantitative, and more complex, test is necessary.
**Alternative Method: Calculation of Loss**

The goodwill impairment loss, if any, represents the excess of the carrying amount of the reporting unit over its fair value as currently measured with a quantitative test. The amount of loss would be limited to the book value of goodwill preceding the test. The Alternative Method simplifies the calculation of any goodwill impairment, as it eliminates “Step Two” of the impairment test under traditional GAAP, as illustrated in Figure 1 above. The process for implementing the goodwill impairment test for private companies electing the Alternative Method is shown below.

![Diagram](image)

The Alternative Method applies prospectively to goodwill existing as of the beginning of the period of adoption, and new goodwill recognized in annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early adoption is permitted, including application to any period for which the entity’s annual or interim financial statements have not yet been made available for issuance. While the Alternative Method should streamline the private company impairment process, a private company electing its use must still assess and support whether a triggering event has occurred during the reporting period. Triggering events may be related to company-specific outlook, industry-specific factors, and/or broader macroeconomic conditions.

### AICPA Accounting and Valuation Guide

The American Institute of Certified Public Accounting (AICPA) through its Financial Reporting Executive Committee (FinREC) issued the AICPA Accounting and Valuation Guide, *Testing Goodwill for Impairment* (the “Guide”) in late 2013. FinREC is the designated senior committee of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. While the Guide is not authoritative, it is a useful aid to valuation professionals, preparers, and auditors by providing an illustrative framework for the testing of goodwill impairment. While goodwill impairment testing has been in place for over a decade, application and practice issues continue to arise and the Guide strives to alleviate some of these.
issues. The Guide is very comprehensive and provides illustrative examples of both Step One and Step Two goodwill impairment tests. The Guide provides insight and clarification on a number of debated or misunderstood issues, a few of which are discussed below.

**Calculation of Carrying Value**

The carrying value of a reporting unit can be calculated on an enterprise value basis or an equity value basis. Accounting guidance doesn't specify a particular approach for calculation of carrying value. The Guide outlines calculation of either approach including an equity approach, where all liabilities, including debt, are available for assignment to the reporting unit. When a reporting unit's carrying amount is based on an enterprise approach, debt is excluded from the liabilities available for assignment to the reporting unit when determining the carrying amount. In situations in which the fair value of debt approximates its carrying amount, using either approach would not be expected to affect the goodwill impairment test. When no debt has been assigned to the reporting unit, the carrying amount of the reporting unit will be the same using either approach. It is important that the preparer apply the correct unit of value to the carrying value in order to alleviate any false positives.

**Reconciliation to Market Capitalization**

In determining fair values of multiple reporting units in a public entity, preparers will often compare the sum of the reporting units to the entity’s overall market capitalization. The Guide highlights common reconciling items between the sum of the reporting unit fair values and that of the entity's market capitalization, including:

- Control synergies – removal of redundant costs and realization of market participant synergies;
- Asymmetric data – internal information not known outside of the company. This information is not included in share prices but would be expected to be obtainable from a market participant’s customary due diligence;
- Tax consequences – the share price would not be reflective of a taxable basis transaction (if this is deemed market participant and included in analysis);
- Entity-specific capital structure – Market participant views drive the fair value of the reporting unit. Accordingly, the share price may reflect suboptimal leverage and therefore differ with that of an optimal capital structure;
- Excess short positions against the stock – excess short positions could cause price volatility; and
- Controlling or large block interests – controlling blocks may influence major decisions and may influence thinly traded (and observable) shares.
Final Thoughts

The interrelationship between accounting information of market participants and the behavior of arm’s length investors is of critical importance to allow effective capital allocation. The complexities of U.S. GAAP seemingly arise from attempts to truly capture the economics of a business when starting from a historical point of view, and in effect, “driving forward by driving in reverse through the rearview mirror.” However, by applying simplified standards, the economics of businesses and/or their transactions may not be captured in the same meaningful manner and may actually serve to increase complexity for investors.

Statements and opinions expressed herein are solely those of the author(s) and may not coincide with those of Houlihan Lokey.