GBQ Consulting

June 2011
Vol. 2011-03

230 West Street
Suite 700
Columbus, OH 43215
614.221.1120
www.gbqconsulting.com

111 Monument Circle
Suite 500
Indianapolis, IN 46204
317.423.0150
www.gbqgoelzer.com

GBQ Goelzer Valuation Services

VALUATION observations

New Goodwill Impairment Rules: Good on Paper, Not So Good in Practice?

By Brian D. Bornino, CPA/ABV, CFA and Kelly C. Noll, CFA

On April 22, 2011, the Financial Accounting Standards Board ("FASB") issued an Exposure Draft to ASC 350 that would alter the process by which both public and nonpublic companies account for goodwill. The stated purpose of this new rule is to simplify the process by which companies conduct goodwill impairment testing. Our view is that this update fails to achieve this goal, and in fact, may reduce the usefulness of financial statements to investors and end users.

Current Rule

U.S. accounting standard ASC 350, *Intangibles – Goodwill and Other*, issued in June 2001, requires a comprehensive, quantitative two-step approach to goodwill impairment testing. Step One of the impairment test includes a valuation of a company's fair value, considering three commonly accepted approaches to value: a market approach, an income approach, and an asset approach, consistent with current valuation theory. These approaches generally consist of an analysis of the earnings capability of the company, an examination of comparable transactions and public companies in the company's industry, and an analysis of the company's underlying assets. If Step One of the impairment test results in a fair value less than recorded value, a second step will be necessary to measure the amount of impairment loss, if any. The current process allows companies to opt-out of the two-step process if the probability of impairment is thought to be remote.

New Rule

The amendments proposed in the Exposure Draft would be effective for fiscal years beginning after December 15, 2011 and early adoption would be permitted. If the proposed amendments in the Exposure Draft are accepted, a company would be permitted to *qualitatively* assess whether its fair value is less than its carrying amount if management determines that there is 50%+ likelihood that goodwill is not impaired. If management deems that goodwill is "more than likely" not impaired, then the company would not need to perform any further impairment analysis. If that is not the case, then the company would proceed to perform the standard two-step impairment process currently required by ASC 350.

(Continued on page 2)

New Goodwill Impairment Rules: Good on Paper, Not So Good in Practice? (continued)

Our Analysis

On the surface, the proposed changes in the Exposure Draft seem to be a sensible option that could reduce the cost and complexity of goodwill impairment testing, particularly for companies where is it is obvious that they are unlikely to be impaired (e.g., performing well ahead of budget, strong industry dynamics, etc.); however, we foresee several important shortcomings:

- **Current "Carry Forward Option" already provides relief from complex quantitative analyses in certain circumstances:** According to ASC 350 paragraph 20-35-29, a detailed determination of the fair value of a reporting unit may be carried from one year to the next if all of the following criteria have been met:

  1. The assets and liabilities that make up the reporting unit have not changed significantly since the most recent fair value determination. (A recent significant acquisition or reorganization of an entity's segment reporting structure is an example of an event that might significantly change the composition of a reporting unit).
  2. The most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin.
  3. Based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, the likelihood that a current fair value determination would be less than the current carrying amount of the reporting unit is remote.

  This option provides cost relief to companies operating in a stable or favorable economic environment without affecting the information reported to users of financial statements. It appears that the qualitative factors one would be consider under the new rule would be the same as those considered under the current rule with the exception that the threshold for allowing only qualitative analysis has been lowered from "remote" chance of impairment to "more likely than not". However, as will be discussed below, we believe the threshold has already been interpreted to mean "more likely than not."

- **Many middle-market, privately held companies are already doing this:** At GBQ, we complete numerous valuations for goodwill impairment testing purposes, and the majority of our clients are middle-market clients. So you would expect that barring instances in which a company's chance of impairment is remote (i.e., companies that should be able to implore the "carry forward" option described above), we would see

(Continued on page 3)

New Goodwill Impairment Rules: Good on Paper, Not So Good in Practice? (continued)

varying degrees of impairment clearance under the assumption that auditors are strict on their interpretation of ASC 350. However, the instances in which we see any meaningful impairment clearance (i.e., fair value is comfortably greater than carrying value) are rare. Further, we often see cases where an auditor will sign-off on a company's goodwill impairment test in one year, only to find the following year that the company has likely been impaired for some time. Thus, it is our experience that most companies are already being held to the "more than likely" standard.

- **Qualitative factors are extremely difficult to audit:** In evaluating whether it is "more than likely" that the fair value of goodwill is less than the carrying amount, relevant events and circumstances shall be assessed. FASB lists examples of such events and circumstances as follows:

  1. Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets;
  2. Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline (both absolute and relative to its peers) in market-dependent multiples or metrics, a change in the market for an entity's products or services, or a regulatory or political development;
  3. Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings;
  4. Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earning;
  5. Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation;
  6. Events affecting a reporting unit such as a change in the carrying amount of its net assets, a more likely than not expectation of selling or disposing all, or a portion of, a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit; and
  7. If applicable, a sustained decrease (both absolute and relative to its peers) in share price.

Although FASB provides an expansive list of qualitative factors to consider, it is also likely that concurrent, quantitative calculations will be performed to determine a range of fair

(Continued on page 4)

New Goodwill Impairment Rules: Good on Paper, Not So Good in Practice? (continued)

value (unless the possibility of impairment is remote, which is already addressed via the "Carry Forward Option"). In our experience, very few auditors have the background to perform reliable fair value calculations, and rules of thumb are oftentimes misleading (again, we often see instances where an auditor will sign-off on a company's goodwill impairment test in one year, only to find the following year that the Company has likely been impaired for some time). It would seem to us that most reputable audit firms would prefer more credible quantitative analysis over subjective qualitative analysis.

- **Threshold is too low:** As we've discussed above, although the "Carry Forward Option" is intended to be used only in remote cases of impairment, it is our experience that auditors have tended to side with their client if they can do so within guidelines; thus, they have not pushed the issue of independent third-party valuation unless impairment was fairly imminent. Now that the standard is slated to become "more likely than not", we suspect that auditors will view this as a signal that they were correct in not pressing clients for goodwill impairment testing and we will see far less fair value calculations… that is, unless goodwill impairment is extremely obvious; at which point, the Company has likely been impaired for some time.

- **Step backwards:** The objective of financial reporting is to provide investors information with which to make informed and relevant investment decisions. In today's dynamic marketplace, investors want to know what an asset is worth today, not what the asset was worth some time ago when it was booked. Fair value measurement, particularly for goodwill and other intangible assets, increases the relevance and transparency of company performance, and, thus, is a good thing as far as investors are concerned.

On another note, fair value has been a standard of measurement in financial reporting for some time, but recently there has been a trend toward an increased use of fair value accounting. Specifically, the FASB and the International Accounting Standards Board ("IASB") have begun a project to "converge" U.S. GAAP, which relies more on rules-based, historical cost measurements, into international accounting standards, which relies more on principles-based, fair value measurements. The Exposure Draft further increases the gap between the treatment of goodwill impairment under U.S. GAAP and IAS (which 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-

(Continued on page 5)

New Goodwill Impairment Rules: Good on Paper, Not So Good in Practice? (continued)

generating units.

Summary

Given the momentum that the Exposure Draft has and the FASB's newfound interest in creating "Big GAAP" and "Little GAAP", we suspect that this Exposure Draft will be adopted after the comment period ends on June 6, and that nearly every company will adopt early to simplify their impairment testing processes. We are hopeful that the quality and integrity of company financial statements is maintained, although we are fearful that the FASB's new rules will result in a goodwill impairment testing process that is… well… impaired.

ABOUT US

GBQ Consulting specializes in Business Valuation, Mergers and Acquisitions, ESOP Consulting, and Dispute Advisory and Forensic Services. Our Business Valuation group is one of the largest and most experienced in the Midwest. Professionals at our offices in Columbus (OH) and Indianapolis (IN) provide valuation services in the following contexts:

- Transaction Support & Opinions
- ESOP Valuation & Consulting
- Succession & Wealth Planning
- Financial Reporting
- Corporate Planning & Assistance
- Expert Opinions & Disputes

CONTACT

Brian D. Bornino, CPA / ABV, CFA, CBA
Director of Valuation Services
bbornino@gbq.com
614.947.5412

Shaun P. Duffin, CPA / ABV, ASA
Manager, Valuation Services
sduffin@gbqgoelzer.com
317.423.0150

Kelly C. Noll, CFA
Senior Financial Analyst
knoll@gbq.com
614.947.5227

Visit our websites
www.gbqconsulting.com
www.gbqgoelzer.com