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VALUATION observations

SEC Offers Guidance on Goodwill Impairment Testing

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As company performance has deteriorated in recent years, auditors are becoming increasingly skeptical of the reported balance sheet values of goodwill and other intangible assets. Thus, goodwill impairment testing (required under ASC 350, formerly SFAS 142) has become a key focus of many audits this year. According to this standard, goodwill must be tested at least annually for impairment under a two step process. The purpose of the first step is to identify potential impairment by comparing the fair value of a reporting unit (as set forth in ACS 820, formerly SFAS 157) to its carrying value, including goodwill. If the reporting unit fails step one, a second step is necessary to determine the amount of the impairment.

One question that has come up several times in the application of this topic is whether the reference to the fair value of a reporting unit refers to its equity value or its enterprise value. Historically, the choice of equity vs. enterprise value would not impact the result of the first step of the impairment test (i.e., pass vs. fail). However, this choice has become a heightened issue over the past year as many companies have experienced a negative book value of equity, which presents a problem for correctly testing for impairment on an equity basis. The SEC recently made light of this issue, addressing it in a December 2009 speech, stating that "one example when the selected approach could impact the result is when carrying value of equity in a reporting unit is negative"; further concluding that "a step one test performed on an enterprise basis would likely provide a better indication of whether a potential impairment of goodwill exists and a step two test should be performed".

> ***SEC: "A step one test performed on an enterprise basis would likely provide a better indication of whether a potential impairment of goodwill exists and a step two test should be performed."***

Example

An example of the impact of choosing the wrong testing basis is as follows:

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SEC Offers Guidance on Goodwill Impairment Testing (continued)

Step One Performed on an *Enterprise Value* Basis

Let's say that company ABC had negative $500,000 of equity, $1.0 million of debt, and $100,000 of cash reported on its balance sheet. Further, the fair value of the company was determined to be $250,000 on an enterprise value basis. In this scenario the carrying value of ABC on an enterprise value basis is $400,000 (see table for calculation), which is greater than ABC's fair value of $250,000. As such, as shown in the adjacent table, ABC would fail step one of the impairment test and the amount of impairment would be determined in step two.

Step One Performed on an *Equity Value* Basis

As mentioned previously, ABC's fair value on an enterprise value basis was determined to be $250,000. To determine the fair value of equity, we take this value and subtract debt of $1.0 million and add cash of $100,000, indicating a negative fair value of equity; however, the fair value of equity cannot be lower than $0. As such, the fair value of equity is determined to be $0. Given ABC's $(500,000) book value of equity, which is less than the fair value of $0, the apparent conclusion is that there is no impairment and thus a step two analysis would erroneously not be performed.

Impairment Analysis

	Testing Basis	
	Enterprise Value	**Equity Value**
Book Value of Equity	$ (500,000)	$ (500,000)
Plus: Debt	1,000,000	
Less: Cash	(100,000)	
Carrying Value	400,000	(500,000)
Fair Value Enterprise/Equity[1]	250,000	0
If Carrying Value > Fair Value, Impairment is Indicated		
Impairment Indicated?	***YES***	***NO***

1- Fair Value of Equity can never be less than $0

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SEC Offers Guidance on Goodwill Impairment Testing (continued)

Conclusion

As illustrated in this example, when the carrying value of equity is negative, a reporting unit would seemingly always "pass" a step one goodwill impairment test when performed on an equity basis, despite the fact that significant goodwill may exist and the underlying operations of that entity may be deteriorating. As such, in accordance with GAAP requirements and SEC guidance, it is important to perform a step one analysis based on enterprise value when the book value of equity is negative.

GBQ Consulting has considerable experience valuing businesses, business interests, and intangible assets for financial reporting and other purposes. The authors can be reached using the contact information below.

ABOUT US

GBQ Consulting specializes in Business Valuation, Mergers and Acquisitions, 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 the following services:

- Transaction Support & Opinions
- ESOP & ERISA Advisory
- Succession & Wealth Planning
- Financial Reporting Services
- Corporate Planning & Assistance
- Expert Opinion Valuations

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