

VALUATION notifications



Caution Urged on New Goodwill Impairment Testing Guidelines

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In an expected move, the goodwill impairment testing alternative for private entities created by the Private Company Council (“PCC”) was released by the Financial Accounting Standards Board (“FASB”). The update to Accounting Standards Codification Topic 350 – *Intangibles – Goodwill and Other* (“ASC 350”) applies only to non-public entities, as public entities will still be required to comply with GAAP. There is a lot of good in the GAAP alternative, primarily for small entities with few outside investors or lenders, but a company should be cautious before proceeding with the election. Let’s start by discussing the changes.

The Changes

The update to ASC 350 now permits an accounting alternative that will allow private companies that adhere to GAAP to amortize goodwill on a straight-line basis over 10 years, or less if it can be demonstrated that another useful life is more appropriate. Companies that elect the alternative will no longer have to do annual goodwill impairment tests. Instead, they would only perform an impairment test in the case of a triggering event, such as a substantial decline in financial performance or the loss of a key customer or employee.

When a triggering event occurs, the company has the option to first assess qualitative factors to determine whether the quantitative impairment test is necessary. If a qualitative assessment indicates that it is more likely than not that goodwill is impaired, the company must then perform a quantitative test similar to a Step I analysis they historically performed to compare the entity’s fair value with its carrying amount, including goodwill. However, it is expected that companies might have a difficult time making a persuasive case in favor of relying on qualitative factors after determining that a triggering event has occurred.

In cases where impairment is identified, it will be recorded simply as the amount by which the book value of an entity (or reporting unit) exceeds the fair value (until the goodwill of the company is gone).

Upon adoption, a company will need to make a policy election regarding whether it will assess goodwill for impairment at an entity-wide level or a reporting unit level. If a nonpublic entity elects to apply the GAAP alternative, it will be required to apply both aspects of the alternative - amortization and the simplified impairment

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test. The standards are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early adoption is permitted, which means that an eligible nonpublic entity could elect to apply the alternative in its 2013 financial statements, as long as those financial statements have not been made available for issuance prior to the release of the final standards.

The Good

The cost savings to a company electing this alternative could be meaningful when expressed in both time and dollars. Since a company will only have to test for impairment when a triggering event occurs, the annual exercise of going through impairment testing would be less frequent. When there is a triggering event, the new rules will simplify the process (and lower the cost) by eliminating the hypothetical business combination allocation analysis prescribed in a typical Step II goodwill impairment analysis. In cases where impairment is identified, it will now be recorded simply as the amount by which the book value of an entity exceeds the fair value (not to exceed the book value of goodwill).

Not so Fast...

Although the new rules will certainly bring about cost savings for some companies, there are many companies that will benefit from (or be required to continue) current accounting practices, so it is imperative to carefully evaluate the company's goals and objectives.

The most common company that will fall into this category is a company whose plans include becoming a public company or pursuing a liquidity event where the potential buyer could be a public company. For example, companies with private equity or venture capital investors are likely poor candidates for the GAAP alternative given that there will be an exit event in a relatively short period of time. This is important because if at any point a company's financial statements are likely to be included in an SEC filing, then electing the GAAP alternative could create difficulties (and substantial costs) related to restating the financial statements to comply with GAAP.

Further, a company should engage its external stakeholders in a meaningful discussion about these scenarios prior to electing the GAAP alternative. The FASB obtained many comment letters from financial institutions expressing concerns that the new alternative will increase the complexity and costs of credit analysis as two otherwise identical companies would have very different financial statements based on the selected accounting treatment. Another example of a circumstance where a company might be a poor candidate for the GAAP alternative relates to how earnings are released to external shareholders. If a company reports its earnings per share ("EPS"), then the additional amortization related to goodwill will have a dilutive impact on

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reported EPS.

Wrapping Up

As mentioned, the GAAP alternative will likely have a positive impact on many smaller firms that have no visions of going public, being acquired, or attracting external investors. However, there are still a significant number of companies that should consider continuing to report under GAAP. The cost and aggravation of restating financial statements in the event of a liquidity event is likely worth the annual investment of performing the Step I analysis under GAAP. The decision may not even be in a company's hands if external stakeholders require the continued use of GAAP guidelines. So prior to electing the GAAP alternative, be sure to have a clear understanding of the long-term goals and objectives of the company and consult your external stakeholders.



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