Duff & Phelps

September 2011

FASB Introduces Qualitative Screen for Goodwill Impairment Testing

On September 15, 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update ("Update") No. 2011-8 *Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. The objective of the Update is to simplify the requirement to test goodwill for impairment. Under the amendments, an entity has the **option,** but is not required, to first assess qualitative factors ("Qualitative Assessment" or "QA") to determine whether it is more-likely-than-not (greater than 50% likelihood) that the fair value of a reporting unit is less than its carrying amount (referred to herein as "failing the QA"). If, after assessing facts and circumstances in the aggregate, an entity determines it does not fail the QA, then performing the traditional two-step impairment test is unnecessary. Otherwise, an entity is required to proceed to the first step of the goodwill impairment test as currently outlined in ASC Topic 350. Under the Update, however, an entity has the unconditional option to bypass the QA and proceed to the usual quantitative test at each reporting date, and can resume performing the QA in any subsequent period. The amendments in this Update do not affect how the first and second steps of the goodwill impairment test are performed.

Factors to Consider in the Qualitative Assessment

Examples of events and circumstances provided in the Update that an entity should consider in a QA include, but are not limited to:

- **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
- **Industry and market considerations** such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development
- **Cost factors** such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows
- **Overall financial performance** such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods
- **Other relevant entity-specific events** such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
- **Events affecting a reporting unit** such as a change in the composition or 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
- **A sustained decrease in share price** (consider in both absolute terms and relative to peers).

These and other relevant factors are to be evaluated based on the weight of the evidence. None of the individual examples are intended to represent standalone factors that would require the first step of the goodwill impairment test to be performed.

More weight would be placed on events and circumstances that most affect a reporting unit's fair value or the carrying amount of its net assets. Positive and mitigating events and circumstances should also be considered. Yet the existence of positive and mitigating events and circumstances is not intended to represent a rebuttable presumption that an entity should not perform the first step of the goodwill impairment test.

If an entity has a recent fair value calculation for a reporting unit, it also should include as a factor in reaching its conclusion about whether to perform the first step of the goodwill impairment test the amount by which the fair value exceeded the carrying amount. Further, the FASB intends for an entity to make a *positive assertion about its conclusion reached* and the events and circumstances taken into consideration if it passes the QA.

Other Highlights

Other noteworthy points and amendments made by this Update include:

- In performing the QA of *reporting units with a zero or negative carrying amount*, an entity needs to consider whether there are significant differences between the carrying amount and the estimated fair value of its assets and liabilities, as well as the existence of significant unrecognized intangible assets. Further, if an entity concludes that it is more-likely-than-not that a goodwill impairment exists, it must perform the second step of the goodwill impairment test, which requires the calculation of the fair value of a reporting unit (among other items). Finally, the examples of factors in the Update supersede the previous examples of events and circumstances that an entity having a reporting unit with a zero or negative carrying amount should consider in determining whether to perform the second step of the ASC Topic 820 goodwill impairment test.
- The ASC 820 quantitative *disclosures about significant unobservable inputs* (Level 3) employed in a goodwill impairment test are no longer required.
- Entities will *no longer be permitted to carry forward* their detailed fair value calculation from a prior year. If an entity determines that a reporting unit fails the QA, then the entity must calculate the current fair value of the reporting unit rather than place reliance on a prior-year fair value calculation. (However, a recent calculation of the fair value of the reporting unit can be used as a factor in performing the QA.)
- The amendments do not change the current guidance for *testing other indefinite-lived intangible assets* for impairment. However, the FASB recently added a project to its agenda to explore alternative approaches to simplify the current model for the impairment testing of indefinite-lived intangible assets.
- The amendments also do not change the guidance about other *events affecting the recognition of goodwill* that require an entity to calculate the fair value of a reporting unit, such as when an entity reorganizes its reporting units or when an entity disposes of a portion of a reporting unit that constitutes a business.

Scope

This Update applies to both public and private companies which have recorded goodwill on the balance sheet. While this project was originally undertaken in response to private company preparers' concerns about the cost and complexity of performing the first step of the two-step goodwill impairment test, FASB decided to expand the scope to public companies as well.

Effective Date

QAs under this Update can be applied for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Earlier adoption is permitted and would include impairment tests performed as of a date before September 15, 2011 if an entity's financial statements for the most recent annual or interim period have not yet been issued.

Convergence with IFRS

The guidance provided in this Update does not advance convergence between U.S. GAAP and IFRS. The impairment model under IFRS is different primarily because International Accounting Standard (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 single- or a group of cash-generating units (CGUs). Further, the IAS 36 test involves a comparison between the carrying amount and the recoverable amount (defined as the higher of value-in-use and fair value less costs to sell) of the CGU, with the excess recorded as an impairment loss. This impairment loss is not limited to the balance of goodwill recorded in the CGU in that other assets within that CGU may also be impaired. IFRS for small and medium-sized entities follows yet another model in which goodwill is amortized. FASB recognized these differences, but viewed this project as short-term and limited in scope, while IFRS convergence is to be addressed more comprehensively.

Our Take on the Update

As practice has shown, it is difficult to attain the same level of comfort in a conclusion based on an array of qualitative factors considered in their totality, compared to the one provided by a quantitative analysis encapsulating the impact of such multiple factors. Entities taking the QA option should be prepared to adequately manage the following factors:

- **Reconciling to market capitalization**: many public entities reconcile the sum of the fair values of the reporting units to the entity's market capitalization. This reconciliation is more challenging when an entity is comprised of multiple reporting units with dissimilar characteristics and value drivers, which may contribute differently to overall share price movements. Further, as a market capitalization reconciliation also depends on the fair value of debt residing at the reporting unit level and/or at the corporate level, a qualitative assessment may fail to capture with sufficient transparency the impact of financing on the fair value of equity.

  Since, ultimately, a market capitalization reconciliation is inevitably quantitative by nature, there is no qualitative approach to accomplish this, albeit it may be possible to rely on ballpark estimates or "bands" of value. Practice has yet to see the level of documentation that both external auditors and the SEC might require to get comfortable that a public entity's goodwill assessments are based on implicit valuations consistent with its market capitalization. Further, it is not clear how taking the QA option will interact with the SEC's quantitative "goodwill-at-risk" disclosures.

- **Making a "positive assertion" as part of the qualitative assessment**: FASB's intent for an entity taking the QA option is for it to make a *positive assertion about its conclusion reached* and the events and circumstances taken into consideration when asserting that the reporting units pass the QA. Although it is held that QAs can be audited and substantiated, it is recognized that significant judgment may be required, especially when evaluating the effect of multiple factors. While factors are to be evaluated in the aggregate, from a practical standpoint, an adverse conclusion with respect to any single significant factor may cast a shadow of uncertainty on the weighting of the factors in the overall conclusion.

  In periods with a negative or uncertain economic outlook and stock market volatility, an entity should be particularly prepared to support the "positive assertion" this Update is seeking. Short-term stock price volatility may put pressure on more-likely-than-not judgments as one would lack the ability to dissect the projections and understand the extent of market overreaction vs. the indication of the business fundamentals at the reporting unit level. In discounted cash flow terms, the overall value conclusion is typically very sensitive to the terminal (or continuing) value, which includes an assessment of factors such as the *long-term growth outlook and risk* inherent in the reporting unit. One would be challenged to make judgments as to the persistence of the near-term performance vs. the long term outlook solely on qualitative grounds. A qualitative evaluation may also fail to capture the insight and match the efficiency of an expected value calculation (underlying a fair value measurement) which considers *various scenarios*, especially when expected variability around that expected value is high and possible outcomes are widely divergent.

- **Keeping on top of reporting unit dynamics**: An entity should be prepared to assess the impact of shared resources among reporting units as well as synergies that would be available to market participants (whether the reporting units are sold standalone or as a group), and the effect of these assumptions on the fair value of the reporting units. The assignment of assets and liabilities into - or out of - a reporting unit based on the criteria in ASC Topic 350 (including, for example, pursuant to a reporting unit restructuring, acquisition, divestiture, or simply based on changes in the use or sharing of assets) will impact both the carrying value and fair value of the reporting units. Also, an entity needs to track macroeconomic, industry and specific factors affecting the performance and outlook of the reporting units, including growth rates, interest rates, competitive outlook, and others, to be able to perform the QA permitted by this Update.

- **Closing the documentation gap**: The level of documentation that would withstand auditor and regulatory scrutiny is yet to be determined. As observed by participants in the FASB workshops related to issuing this Update, in the absence of prescriptive guidance and illustrative examples there may be variation in how some companies evaluate the effect that various events and circumstances may have on a reporting unit's fair value or its carrying amount. Further, there may be an "expectation gap" about the level of rigor and documentation inherent in a QA that is provided by entities and acceptable by auditors and regulators. While the QAs may be auditable, feedback from the FASB's workshops indicated that they may not be easily auditable.

Ultimately, by addressing the factors above, entities employing the QA option need to be able to manage the following risks:

- **Perception risk**: avoiding the perception of delaying the recognition of a goodwill impairment.

- **Execution risk**: risk of suboptimal documentation, leading to increased costs in rectifying the issue upon external review. Or, alternatively, arriving at judgments in the QA step which differ from those of the auditor or regulator, and having to resolve the disparity via a quantitative approach.

On balance, we believe that the QA option may be better suited to fulfill its objective of reducing costs and complexity under a combination of circumstances including a favorable economic environment, single- or simple reporting unit structures, and consistent entity operating performance. In many other circumstances, *we view a periodic quantitative Step 1 test as a potential practical fallback substantiating current and future QAs*. Further, some form of quantification would be needed to perform an adequate reconciliation to total market capitalization for public entities. We expect that initially, upon implementation of this Update, the documentation would rely on a quantitative benchmark, e.g., the fair value of the reporting unit indicated by the most recent impairment test, and a process to bridge this valuation to a current assessment date.

How Duff & Phelps Can Help

To assist entities seeking to perform a QA, we can provide a variety of empirical data points which can be leveraged into the more-likely-than-not determination. For example, we can provide a periodic analysis of market inputs, including market multiples, discount rates, macroeconomic indicators and other data that can be incorporated in the documentation supporting the QA.

From an implementation standpoint, entities should establish a framework for performing QAs, which might include building a *matrix* which reflects the pertinent events and circumstances listed in this Update and any additional relevant factors, such as value drivers of the various reporting units. Entities should be able to transparently track changes in these factors over time, while possibly bridging periodic quantitative tests, where needed. We can provide such benchmark value assessments and sensitivities as well as assistance both in the identification and dynamic tracking of various market-based inputs impacting value.

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