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Valuation Perspective: ASU No. 2011-08

In September 2011, the FASB released Accounting Standards Update No. 2011-08 (the “Update”) relative to FASB Accounting Standards Codification (“ASC”) Topic 350 – Intangibles-Goodwill and Other (“Topic 350”). The Update amends Topic 350 and provides guidance for implementation. The ASC is the authoritative source of generally accepted accounting principles for nongovernmental entities.

Background and Overview

According to the FASB, the objective of the Update is to simplify how entities, both public and private, test goodwill for impairment. The Update is intended to address concerns from companies (primarily private companies) regarding the cost and complexity associated with the goodwill impairment test process.

By way of background, prior guidance under Topic 350 required an entity to test goodwill for impairment by comparing the fair value of a reporting unit with its carrying amount. If the fair value of a reporting unit is determined to be less than the carrying amount, then the second step of the test should be performed to measure the amount of the impairment loss, if any.

The Update provides that an entity is not required to calculate the fair value of a reporting unit unless the entity first determines that “it is more likely than not”¹ that its fair value is less than its carrying amount. Specifically, the Update provides companies with an option to first assess *qualitative* factors to determine whether the existence of events or circumstances lead to a conclusion that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If it is determined that it is *not* more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step quantitative impairment test is unnecessary. If, however, the opposite conclusion is reached, then the first step of the two-step quantitative impairment test is required in order to gauge whether or not impairment exists.

Under the amendment, entities have the option of bypassing the qualitative assessment and proceeding directly to the quantitative test. In such cases, entities may resume performing the qualitative assessment in subsequent periods.

The Update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. However, early adoption is permitted, including for impairment tests performed as of dates prior to September 15, 2011 (provided that the entity’s financial statements have not yet been issued).

Qualitative Considerations

Topic 350-20-35-3C lists examples of qualitative factors and circumstances which should be considered in assessing whether or not the fair value of a reporting unit is less than its carrying amount. Some examples, excerpted from the Update, follow below:

- 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, a change in the market for an entity’s products or services, or a regulatory or political development;
- 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 changes 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; and
- If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers).

¹ Defined by the FASB as a likelihood of greater than 50%.

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The amended guidance further indicates that the examples listed above are not all-inclusive, and that entities should consider other relevant events and circumstances that may affect fair value. The various factors are to be evaluated in combination (i.e., no single factor will necessarily require the quantitative test), and the FASB specifically notes that the existence of positive and mitigating events and circumstances is not intended to represent a rebuttable presumption that an entity need not perform the quantitative test.²

Observations

Prior to proceeding, it is worth noting the primary reason underlying the release of the Update was to address concerns about the cost and complexity of performing the first step of the two-step quantitative impairment process.

One observation pertaining to the Update is that the qualitative test may not be as simple as it sounds. The qualitative test is one that will require significant judgment and a major time commitment on the part of financial managers. At the risk of stating the obvious, the time commitment presents an added soft cost for financial managers.

In performing the qualitative test, entities must consider all qualitative factors which may have a meaningful impact on fair value, and then weight them in combination to make an assessment as to whether or not fair value more likely than not exceeds carrying value. To compound matters, the qualitative assessment may result in an unclear conclusion.

In addition, financial managers will likely have to expend time and resources outlining and reviewing, frequently in the form of an accounting memorandum, the many qualitative considerations which were part of their assessment. And, not to be forgotten, upon deriving a final conclusion, financial managers must present, discuss and, in some cases, defend this conclusion to their auditors – again, a process which can also be arduous and time consuming.

Another observation relative to the Update is that many of the *qualitative* factors outlined by the FASB are actually *quantitative* factors. Among the factors listed by the FASB are industry and market considerations, market multiples, actual and projected financial performance, and so forth. All of these factors would be considered in a quantitative analysis. Thus, it seems that in order to complete the *qualitative* assessment, management must address many of the considerations which were traditionally part of a step one *quantitative* goodwill impairment test.

We note that the Update results in a trade-off; that is, the exchange of a hard cost (i.e., paying an independent third party for the quantitative impairment test) for a soft cost (i.e., the added time and expense involved with assessing qualitative factors). Further, if the auditors don't agree with management's conclusion under the qualitative test, the company might in the end be forced to pay the incremental hard cost anyway – in such cases, the FASB has effectively created a three-step impairment test!

Practical Considerations

In light of the extra burden associated with the qualitative test, we recommend that financial managers begin speaking with their auditors early about the impairment test process. Remember, the Update is new for everyone—accounting firms are likely contemplating how they will audit the qualitative test. Financial managers should seek to gain an understanding of auditor expectations with respect to procedures and documentation. Ample time should be allowed for dialogue and review; therefore if it is ultimately decided that an independent quantitative test is necessary, such test can be obtained without delaying the issuance of financial statements.

We also believe it is important to bear in mind the fact that the quantitative test has not been eliminated – a quantitative impairment test will likely be required at some point. For example, all other factors constant, an unfavorable economic environment alone may necessitate a quantitative test for many entities. In this regard, we recommend financial managers continue to maintain close working relationships with valuation practitioners.

Finally, we recommend that financial managers importantly consider the tradeoff between an internal qualitative test and an external independent valuation. After an analysis of time and cost to prepare the qualitative test, we believe many financial managers will conclude that an independent valuation is a cost effective alternative. Importantly, we believe the preparation of an independent quantitative impairment test remains a best practice. Therefore, we recommend financial managers continue to pursue outside impairment tests to the extent the cost is manageable.

² Topic 350-20-35-3G.