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McGladrey & Pullen
Certified Public Accountants

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Goodwill Impairment Application Issues

Introduction

Both auditors and preparers of financial statements are dealing with a number of very judgmental issues involving fair value and asset impairments in the current environment. This white paper addresses certain application issues that may arise when evaluating goodwill for impairment under FASB Statement No. 142, *Goodwill and Other Intangible Assets*, including the valuation of a reporting unit and debt, as well as certain deferred tax issues.

Valuation of a Reporting Unit

Statement No. 142 states that goodwill should be tested for impairment at least annually using a two-step process. In Step 1, a company must measure the fair value of a reporting unit and compare this fair value to the reporting unit's carrying amount to determine if there may be impairment. The measurement of a reporting unit's fair value is often done at either an Equity Level of ownership or an Enterprise Level of ownership. An improper determination of the level at which a reporting unit's fair value is measured may result in an inappropriate conclusion as to whether a reporting unit passed or failed Step 1. For purposes of this white paper, we define these levels of ownership as follows:

- Equity Level - the level that represents the value attributable to equity holders only, and therefore includes the cash outflows related to interest-bearing debt
- Enterprise Level - the level that represents the value attributable to both debt and equity holders, and therefore excludes the cash outflows related to interest-bearing debt (also referred to as Market Value of Invested Capital)

Statement No. 142 does not directly state the level at which the fair value of a reporting unit should be determined in all cases. In other words, it does not directly state whether the fair value should be determined at an Enterprise Level or at an Equity Level. However, paragraph 32 notes that assets and liabilities should be assigned to a reporting unit if

- The asset will be employed in or the liability relates to the operations of a reporting unit; and
- The asset or liability will be considered in determining the fair value of the reporting unit.

Consistent with paragraph B116 of Statement No. 142 and as noted previously, to make an "apples-to-apples" comparison of a reporting unit's fair value to its carrying amount, the determination of the level at which a reporting unit should be valued is driven by the assets and liabilities assigned to that reporting unit. For example, if certain debt is assigned to a reporting unit, then when determining the fair value of that reporting unit there must be consideration of the cash outflows that would result from that debt (*i.e.*, interest and principal repayments). In other words, the fair value cannot be determined at an Enterprise Level because debt has been assigned to the reporting unit.

Statement No. 142 does allow for certain corporate assets and liabilities (such as debt) to remain unassigned to a reporting unit if either of the two criteria noted previously for assignment are not met. Therefore, it would be appropriate for a multiple reporting unit entity to determine the fair value of its reporting units at an Enterprise Level if debt is not assigned to those reporting units, and then compare that fair value to the reporting unit's carrying amount, which would also exclude debt.

We have noted information in valuation journals stating that Statement No. 142 is not specific about the level at which a reporting unit should be valued. Further, we have observed that many third-party valuation firms often determine the fair value of a reporting unit at the Enterprise Level and compare this fair value to the reporting unit's carrying amount excluding debt. This is relatively common and is often done without regard to which assets and liabilities have been assigned to the reporting unit. We believe this valuation level may be appropriate for multiple reporting unit entities as previously stated, but we do not think it is appropriate for a single reporting unit entity. In November 2002, the Emerging Issues Task Force (EITF) agenda committee considered this issue but did not include it on their agenda. However, the agenda committee stated that "in its view, if an entity has only one reporting unit, all of the entity's assets and liabilities should be included in that reporting unit." Given this view and the fact that the level at which a reporting unit's fair value is determined is driven by the assets and liabilities assigned to it, we believe that the fair value of a single reporting unit entity must be determined at an Equity Level and may not exclude company debt. While this view is technically not stated in generally accepted accounting principles, it is widely followed in practice. Furthermore, we note that consistent with this view, if a single reporting unit entity has negative equity (due to a significant amount of debt, for example), practice is that because all assets and liabilities of a single reporting unit entity must be assigned to its sole reporting unit, its goodwill could not be impaired as its fair value would always be greater than its carrying amount (assuming there are no shareholder funding commitments).

Single reporting unit entities that have valued their sole reporting unit at an Enterprise Level can still utilize this value as a starting point. However, this value must be reduced to the Equity Level by removing the fair value of the company's debt. When comparing the Equity Level fair value to a reporting unit's carrying amount, the carrying amount should also be adjusted by including the associated debt in order to have an "apples-to-apples" comparison. Some believe that determining fair value at an Enterprise Level and comparing it to a reporting unit's carrying amount excluding debt will have the same result as when determining fair value and comparing it to a reporting unit's carrying amount at the Equity Level. However, as illustrated below, this will not always be the case since the fair value of debt must be removed from the Enterprise Level fair value of the reporting unit and the carrying amount of debt must be included in the carrying amount of the reporting unit (as a reduction) when testing at the Equity Level. This could result in a different answer for Step 1 when performed at an Equity Level vs. an Enterprise Level. In particular, given the current economy in which the fair value of debt is often less than its carrying amount, performing Step 1 at the Equity Level could result in passing while performing Step 1 at the Enterprise Level could result in inappropriately failing.

The following two simple examples illustrate this concept by comparing a goodwill impairment test for a single reporting unit entity at the Enterprise Level vs. the Equity Level. However, note that these examples do not discuss all considerations required in Steps 1 and 2 of Statement No. 142.

Example 1 – Enterprise Level Test (inappropriate for a single reporting unit entity)

Assume a reporting unit with the following carrying amounts:

Net Current Assets	$ 500
Goodwill	2,000
Total Assets	2,500
Debt	1,500
Stockholders' Equity	$1,000

Assume the company determined that this reporting unit's fair value at the Enterprise Level (as opposed to the Equity Level) was $2,200. This fair value was determined by weighting 50% to the income approach and 50% to the market approach. The income approach fair value of $2,400 was a direct measurement of enterprise value using discounted debt-free cash flows while the market approach fair value of $2,000 was based on the reporting unit's market capitalization plus a control premium ($1,000) plus the fair value of its debt ($1,000).

The reporting unit's fair value (($2,400 + $2,000)/2 = $2,200) was less than its carrying amount ($2,500 excluding debt). As a result, the reporting unit failed Step 1 and must determine its potential goodwill impairment under Step 2, which is not illustrated here.

Example 2 – Equity Level Test (appropriate for a single reporting unit entity)

Assume the same facts as in Example 1, except that the company determined this reporting unit's fair value at the Equity Level (as opposed to the Enterprise Level), as it was a single reporting unit entity. The reporting unit's fair value at the Equity Level was $1,200 based on the same 50% weighting noted in Example 1 and the following amounts from the income and market approaches:

Income Approach:

Enterprise Value	$2,400	(per Example 1)
Less: Fair Value of Debt	1,000	(per Example 1)
Income Approach Fair Value	$1,400	
Market Approach Fair Value	$1,000	(calculated directly based on market capitalization plus a control premium as noted in Example 1)

This reporting unit's fair value (($1,400 + $1,000)/2 = $1,200)) was greater than its carrying amount ($1,000 including debt). As a result, this reporting unit passed Step 1 and therefore is not required to perform the Step 2 goodwill impairment test.

In practice, we also have seen the Step 1 fair value initially determined at the proper level for a reporting unit (as in Example 2), but the Equity Level fair value of the reporting unit was determined by improperly removing the carrying amount of debt from the Enterprise Level fair value as opposed to the fair value of debt. As noted in Example 3 following, this can also result in an improper conclusion in Step 1 of the goodwill impairment testing.

Example 3 – Equity Level Test Improperly Using Carrying Amount of Debt in Fair Value Determination (inappropriate for any reporting unit)

Assume all the same facts as in Example 2, except that the company improperly removed the carrying amount of debt (as opposed to the fair value of debt) when determining this reporting unit's fair value. The reporting unit's fair value was $950 based on the same 50% weighting noted in Example 2 and the following amounts from the income and market approaches:

Income Approach:

Enterprise Value	$2,400	(per Example 1)
Less: Carrying Amount of Debt	1,500	(per Example 1)
Income Approach Fair Value	$ 900	
Market Approach Fair Value	$1,000	(calculated directly based on market capitalization plus a control premium as noted in Example 1)

This reporting unit's fair value (($900 + $1,000)/2 = $950) was less than its carrying amount ($1,000 including debt). As a result, this reporting unit failed Step 1 and must determine its potential goodwill impairment under Step 2, which is not illustrated here.

While the prior discussion and examples focus primarily on single reporting unit entities, certain issues should also be considered for multiple reporting unit entities related to their reconciliation to market capitalization if they are publicly traded. Although not explicit in Statement No. 142, practice has developed that a reconciliation to support the differences between the fair value determined based on market capitalization plus an appropriate control premium at the impairment testing date and the fair values determined based on other valuation techniques should be performed. Multiple reporting unit entities often appropriately do not allocate corporate debt to each of their individual reporting units (if the debt does not meet the assignment criteria per paragraph 32 of Statement No. 142 as noted previously) and therefore fair value is determined for each reporting unit at an Enterprise Level. As a result, if these Enterprise Level fair values are aggregated without adjustment and compared to the company's market capitalization plus an appropriate control premium, the comparison will not be on an "apples-to-apples" basis as the fair value based on market capitalization plus an appropriate control premium is at an Equity Level while the aggregate fair value of the reporting units is at an Enterprise Level. As a result, the aggregate fair value of the reporting units must be reduced by the fair value of the company's debt in order to make a proper comparison to the market capitalization plus an appropriate control premium at the Equity Level. Alternatively, a comparison may be made at the Enterprise Level by increasing the market capitalization plus an appropriate control premium by the fair value of the company's debt.

Valuation of Debt

As previously discussed, in certain instances the fair value of debt must be considered in Step 1 of Statement No. 142. Furthermore, the fair value of debt also must be considered in Step 2 of Statement No. 142, which requires a hypothetical purchase price allocation of the fair value determined in Step 1 to all assets and liabilities based on FASB Statement No. 141, *Business Combinations*. The guidance in Statement No. 141 generally states that this purchase price allocation should be done based on the estimated fair value of assets and liabilities, but describes in some instances a method that differs from fair value. For example, paragraph 37g of Statement No. 141 states that the amount assigned to accounts and notes payable, long-term debt, and other claims payable shall be based on the present values of amounts to be paid determined at appropriate current interest rates, which is not consistent with the definition of fair value in Statement No. 157, *Fair value Measurements*. As a result, one may believe based on this guidance that the Step 2 allocation to debt should be based on present values of amounts to be paid and not on fair value per Statement No. 157, since Statement No. 157 does not eliminate certain practicability exceptions to fair value in other guidance such as Statement No. 141. However, although paragraph 37g of Statement No. 141 was not superseded or modified, it was interpreted by EITF Issue No. 98-1, "Valuation of Debt in a Purchase Business Combination". This Issue notes that the amount assigned to debt in a business combination should be based on its fair value. As a result, we believe the amount assigned to debt does not meet the practicability exception in Statement No. 157 and should therefore be based on fair value per the definition in Statement No. 157.

When valuing debt based on the guidance in Statement No. 157, consideration must be given to factors other than simply changes in the interest rate since the date of debt issuance. In particular, an entity must consider changes since the date of debt issuance in its own nonperformance risk, including credit risk, from a market participant's point of view. This consideration is often overlooked and may cause a significant change in the debt's fair value. In the current environment, this can often result in a fair value for debt that is significantly less than the carrying amount of the debt.

Deferred Tax Issues

When performing goodwill impairment testing under Statement No. 142, deferred taxes are often overlooked or not considered until late in the process. Certain deferred tax issues arise under Statement No. 142 that are addressed in EITF Issue No. 02-13, "Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in FASB Statement No. 142". When determining the fair value of a reporting unit in Step 1 of Statement No. 142, an entity must consider whether the reporting unit could be bought or sold in a taxable or nontaxable transaction. This determination is judgmental and must consider the structure a marketplace participant would incorporate into their fair value estimate, the feasibility of the assumed structure, and which structure would result in the highest economic value to the seller. When evaluating the feasibility of a nontaxable transaction, an entity must consider whether any income tax laws or other regulations or requirements could limit the use of this structure in a sale of the reporting unit. Regardless of the assumed structure in determining the fair value of a reporting unit, an entity must include deferred taxes relating to a reporting unit's assets and liabilities as part of the reporting unit's carrying amount in Step 1.

When performing Step 2 of Statement No. 142, the income tax bases of an entity's assets and liabilities should be those implied in the tax structure assumed when determining the fair value of the reporting unit in Step 1. If fair value was determined on a nontaxable basis, this generally results in the tax bases of an entity's assets and liabilities remaining unchanged in the Step 2 allocation. However, this does not mean that an entity's deferred tax asset/liability for purposes of the Step 2 allocation will equal its carrying amount. This is generally not the case as in Step 2, the fair value of an entity's assets and liabilities are hypothetically determined for allocation purposes and usually will differ in some respects from their carrying amounts. As a result, the book-tax basis difference would change and therefore the deferred tax balance utilized in Step 2 will generally differ from the carrying amount of the deferred taxes. If fair value was determined on a taxable basis in Step 1, generally there will be no book-tax basis difference and therefore there will be no amounts allocated to deferred taxes in Step 2.