

THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

# BDO KNOWS: **GOODWILL IMPAIRMENT**



## ► EXECUTIVE SUMMARY

In August, the Financial Accounting Standards Board (FASB) relaxed its goodwill impairment standard so companies will be able to avoid the cost of developing detailed fair value estimates for their reporting units in some cases.<sup>1</sup> The FASB decided to provide companies with a new option to determine whether it is necessary to apply the traditional two-step impairment test.<sup>2</sup> If a company elects to use the option, it must decide – on the basis of qualitative information – whether it is more than 50% likely that the fair value of a reporting unit is less than its carrying amount. If so, the existing quantitative calculations in steps one and two continue to apply. But if management concludes that fair value exceeds the carrying amount, neither of the two steps in the current goodwill test is required. The new option applies to both public and private companies, and will be available for early adoption in the third quarter of 2011.

This newsletter summarizes the new standard and includes our observations on initial implementation.

## ► BACKGROUND

In the past, companies have calculated a reporting unit's fair value in the first of two steps for assessing impairment. If the fair value of the reporting unit is more than its carrying amount, there is no impairment. If fair value is less, a second step of analysis is performed to determine the amount of impairment, if any. Public companies with only one reporting unit often used market capitalization to estimate fair value in step one. However, private

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<sup>1</sup> While the FASB made its decision in August, ASU No. 2011-08, *Testing Goodwill for Impairment*, was issued on September 15, 2011. The ASU may be accessed by clicking [here](#).

<sup>2</sup> See ASC 350—Intangibles—Goodwill and Other—Goodwill

companies would commonly prepare a discounted cash flow projection or obtain a valuation report from a consultant to estimate fair value. Public companies with multiple reporting units faced similar circumstances.

As indicated in its press release, “The [FASB’s] decision...comes as a direct result of what we heard from private companies, which had expressed concerns about the cost and complexity of performing the goodwill impairment test,” states FASB member Daryl Buck. “The amendments approved by the FASB address those concerns and will simplify the process for public and nonpublic entities alike.”

## ► MAIN PROVISIONS

As discussed in ASU 2011-08:

- The amendments allow companies to first assess qualitative factors to determine whether it is necessary to perform the current two-step quantitative goodwill impairment test in ASC 350.
- Companies will no longer be required to calculate the fair value of a reporting unit<sup>3</sup> unless a determination is made, based on a qualitative assessment, that it is more likely than not (i.e., greater than 50%) that the fair value of a reporting unit is less than its carrying amount.
- The amendments also allow companies to skip the optional qualitative assessment and continue applying the existing two-step test.
- If a company opts not to use the qualitative assessment in one period, it may resume performing the qualitative assessment in any subsequent period.
- Paragraph 350-20-35-3C provides new examples of the factors to consider in conducting the qualitative assessment.<sup>4</sup> However, the ASU does not provide a comprehensive example of *how* an entity concludes, on the basis of available evidence, whether the traditional step one is required. Rather, that judgment will depend on individual facts and circumstances. A flowchart for performing the assessment is included in Appendix I, and our thoughts on implementation are provided below.
- No new disclosures are required under the ASU. However, SEC registrants should consider the provisions in Item 303 of Regulation S-K to disclose material trends and uncertainties in MD&A, as well as the guidance in Release 33-8350 regarding disclosures about critical accounting estimates. Further, all companies should consider disclosing whether they have elected to perform the new qualitative assessment in their significant accounting policies footnote.<sup>5</sup>

Note, ASU 2011-08 does not change when companies are required to test goodwill for impairment (annually, and during interim periods if a triggering event occurs). Instead, the ASU addresses the frequency with which companies will be required to develop quantitative estimates of fair value when goodwill is assessed for impairment.

## ► IMPLEMENTATION CONSIDERATIONS

For companies that choose to perform the new assessment, a key challenge will be identifying the proper factors that drive the analysis.<sup>6</sup> A qualitative assessment that improperly weights one factor over another, or that fails to consider relevant data will be flawed in the same way that a discounted cash flow projection produces a poor estimate of fair value when the underlying growth rate is too optimistic, or the discount rate is too low given the business risks associated with the reporting unit.

In this light, the new qualitative assessment can be compared to a cash flow model prepared using a spreadsheet that depends on two key components: i) the mechanical accuracy of the calculations, and ii) the integrity of the underlying assumptions. The new qualitative assessment is essentially focused on the second component and represents a fair value estimate of the reporting unit “without the numbers.”

Given this backdrop, companies may find the following framework useful when performing the qualitative assessment:

1. Develop a list of factors that *potentially* apply – In Appendix II, we have compiled a list of impairment triggers based largely on existing literature related to the recoverability of long-lived assets. After reviewing the list, those items that are deemed irrelevant to the fair value of the reporting unit should be disregarded.
2. Add any additional relevant factors based on management’s knowledge of the reporting unit. Note that the examples in Appendix II are not all-inclusive, and companies should consider other relevant facts and circumstances. This step is designed to address the risk of

<sup>3</sup> Under current US GAAP (ASU 2010-28), reporting units with zero or negative carrying amounts are required to perform a qualitative assessment instead of quantitatively comparing the reporting unit’s fair value to its carrying amount in step one. If a company concludes that goodwill is more likely than not impaired, then step two of the traditional impairment test is required to measure the actual amount of impairment, if any.

<sup>4</sup> The new factors are reproduced in Appendix II.

<sup>5</sup> ASC 235-10-50-1 requires “a description of all significant accounting policies...as an integral part of the financial statements.”

<sup>6</sup> Many public companies with only one reporting unit may find it cost/beneficial to continue performing step one of the traditional two-step test based on market capitalization.

reaching a judgment on the basis of incomplete information. Sources of other possible factors include information commonly shared with the company's board of directors and stakeholders, such as analysts, bankers, key customers and vendors, insurance providers, industry associations, etc.

3. Assess whether indicators are easily verifiable, or not. For example, a failure to meet budget forecasts for the current year would be verifiable. A change in market share for the reporting unit's products or services may not be easily verifiable.
4. Categorize the remaining factors (both positive and negative) as either entity-specific, or not.
5. Weight each factor (such as high or low relevance) or apply a scoring system (such as 1, 2 or 3). The ASU's requirement on this point is to:
 

"consider the extent to which each of the adverse events and circumstances identified could affect the comparison of a reporting unit's fair value with its carrying amount. An entity should place more weight on the events and circumstances that most affect a reporting unit's fair value or the carrying amount of its net assets. An entity should also consider positive and mitigating events and circumstances that may affect its determination...."

When determining the appropriate weights to assign, keep in mind relevant observable inputs are always preferred to unobservable inputs when estimating fair value.<sup>7</sup>

6. Form a preliminary conclusion regarding whether the fair value of a reporting unit is more or less than its carrying amount.
7. Determine whether the positive and negative factors are consistent with the assumptions used in other estimates reflected in the financial statements. For example, are cash flow assumptions in the company's impairment tests for deferred income taxes and fixed assets consistent with factors considered in the qualitative assessment of the reporting unit's fair value? What about public earnings guidance or other forward-looking information conveyed in MD&A?
8. Public companies should consider whether the qualitative assessment is supported or contradicted by their quoted stock price.
9. All companies (public and private) should consider whether the qualitative assessment is corroborated by the results any efforts to issue debt or equity securities. This includes successful and unsuccessful offerings.
10. Revise or affirm the preliminary conclusion, as appropriate.

Once management completes its initial assessment, it should be updated as facts and circumstances change. We would ordinarily expect the relevant factors and their weights to remain consistent each period if the underlying business conditions have not changed since the last assessment.

In addition, some companies may have performed a detailed determination of the reporting unit's fair value recently. In those circumstances, management should consider the amount of "headroom"<sup>8</sup> indicated by the prior analysis in the current qualitative assessment. The FASB did not specifically define the term "recent." However, it appears the FASB's intent was substantially less than one year. It stated "The Board concluded that an entity would no longer be permitted to carry forward a reporting unit's fair value calculation from a prior year as previously permitted....The Board reached that conclusion because if an entity determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then the entity must calculate the current fair value of the reporting unit rather than place reliance on a prior year fair value calculation." As such, we would expect a "recent" fair value determination to be most relevant when the following conditions have been met:

- The assets and liabilities that make up the reporting unit have not changed significantly since the most recent fair value determination. (A recent significant acquisition or a reorganization of an entity's segment reporting structure is an example of an event that might significantly change the composition of a reporting unit.)
- The recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin.

As the length of time since the last detailed determination of fair value approaches one year, we would expect its relevance to a current qualitative assessment to diminish.

Companies may also wish to consider obtaining assistance from a valuation professional. While the traditional "full valuation report" may not be necessary under ASU 2011-08, management may find it cost-effective to discuss which of the identified factors have the most relevance to a fair value determination with a valuation professional. Management might also obtain support for its conclusion with a "schedule-only" quantitative valuation report for the reporting unit. The schedule-only report provides the same quantitative estimate of fair value as the full valuation report without the accompanying narrative discussion of the general economy, the reporting unit's industry or its financial performance. In many cases, a schedule-only report is priced 40%-50% less than the comparable full valuation report.

<sup>7</sup> ASC 820-10-35-16AA

<sup>8</sup> The term "headroom" refers to the amount by which the fair value of a reporting unit exceeds its carrying amount.

A schedule-only report may be of particular use the first time management performs the qualitative assessment. Specifically, it may be helpful to determine whether management would reach the same conclusion under the new ASU as it would relying on a quantitative fair value estimate of the reporting unit. If not, it may be necessary to reconsider the analysis behind the qualitative assessment.

Lastly, management's thought process for performing the qualitative assessment should be thoroughly documented in a timely manner.

## ► EFFECT ON REPORTING UNITS WITH NEGATIVE EQUITY (ASU NO. 2010-28<sup>9</sup>)

For reporting units with zero or negative carrying amounts, companies are required to perform a similar qualitative assessment to determine whether it is more likely than not that goodwill is impaired (as opposed to an evaluation of the fair value of the reporting unit). If it is more than 50% likely that goodwill is impaired, then step two of the traditional impairment test is required. ASU 2011-08 makes two changes to the initial qualitative assessment for reporting units with negative equity:

- First, companies are required to consider the new list of events and circumstances in ASU 2011-08, rather than those previously contained in 350-20-35-8A (a significant adverse change in legal factors or in the business climate, an adverse action or assessment by a regulator, etc.).<sup>10</sup> This includes attributing more weight to the events and circumstances that most affect the fair value or the carrying amount of goodwill.
- Second, companies are required to take into consideration whether there are significant differences between the carrying amount and the estimated fair value of a reporting unit's assets and liabilities, including the existence of significant unrecognized intangible assets.

We do not expect these changes to significantly change practice for reporting units with zero or negative amounts of equity.

## ► EFFECTIVE DATE AND TRANSITION

The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including annual and interim goodwill impairment tests performed before September 15, 2011, if the financial statements have not yet been issued, or for private companies, have not yet been made available for issuance.

## ► ON THE HORIZON

Based on feedback on the exposure draft that preceded ASU 2011-08, the FASB recently added a new project to its short-term agenda to explore alternative approaches for simplifying how indefinite-lived intangible assets other than goodwill are tested for impairment. The FASB currently expects to finalize that ASU by mid-2012. Project details are available [here](#).

<sup>9</sup> When to Perform Step 2 of the Goodwill Impairment Test for Reporting units with Zero or Negative Carrying amounts

<sup>10</sup> The new list of events and circumstances is codified in ASC 350-20-35-3C.

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### ► CONTACT:

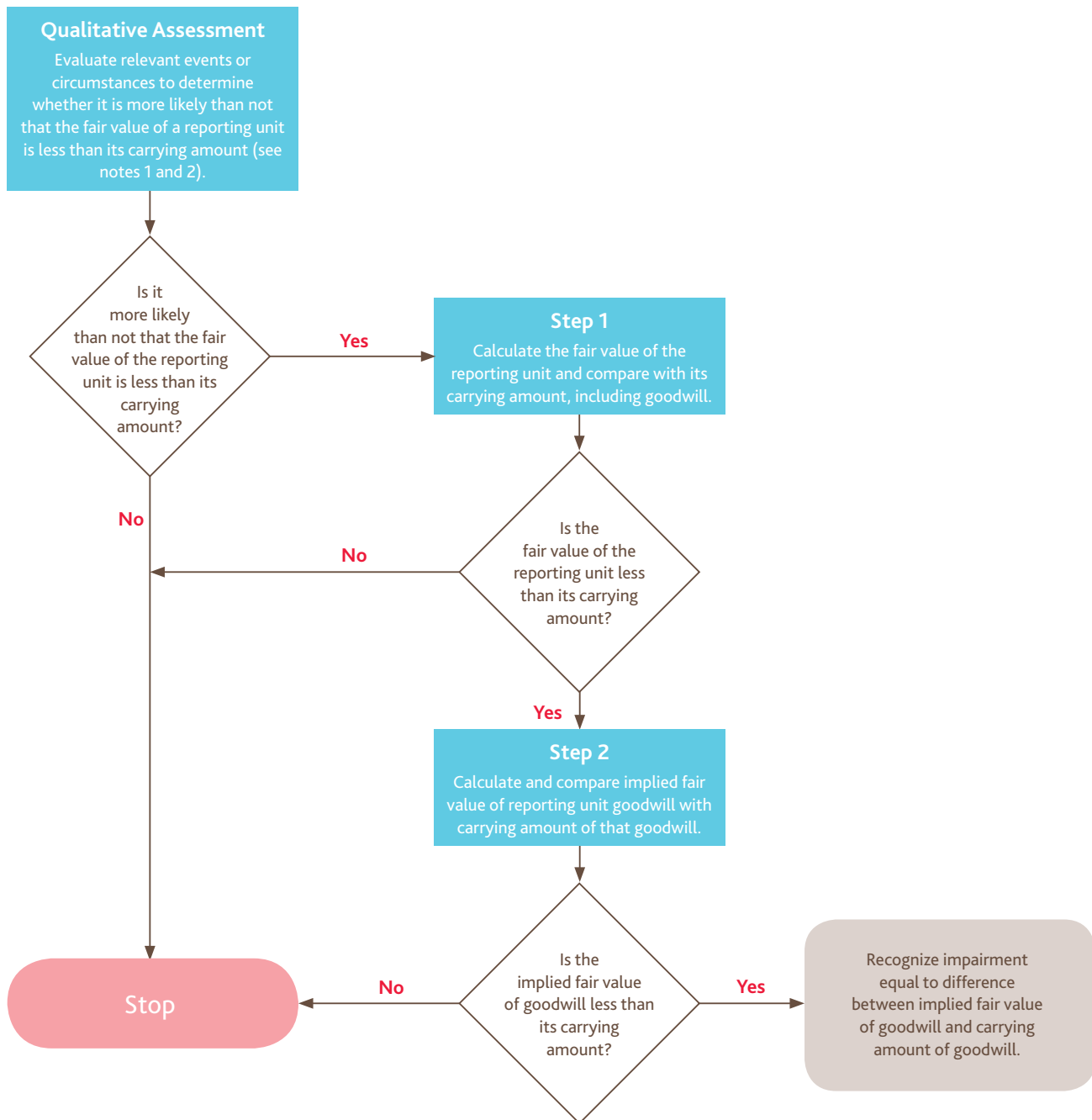
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## ► APPENDIX I – GOODWILL IMPAIRMENT TEST FLOWCHART <sup>11</sup>



### Notes:

1. An entity has the unconditional option to skip the qualitative assessment and proceed directly to performing Step 1, except in the circumstance where a reporting unit has a carrying amount that is zero or negative.
2. An entity having a reporting unit with a carrying amount that is zero or negative would proceed directly to Step 2 if it determines, as a result of performing its required qualitative assessment, that it is more likely than not that a goodwill impairment exists. To perform Step 2, an entity must calculate the fair value of a reporting unit.

## ► APPENDIX II – FACTORS TO BE CONSIDERED WHEN GOODWILL IS ASSESSED FOR IMPAIRMENT

Note: Many of the following impairment triggers are stated in the negative, such as “macroeconomic conditions have deteriorated.” The qualitative assessment under ASU 2011-08 includes all positive and negative factors. Therefore, companies should consider each of the factors below and the opposite condition, such as “macroeconomic conditions have improved.”

**ASU 350-20-35-3A:** An entity may assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount, including goodwill.

**ASU 350-20-35-3C:** In evaluating whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, relevant events and circumstances shall be assessed. Examples of such events and circumstances include the following:

Factors	Opposite Condition		Relevant		Entity Specific		Verifiable		Weight	
	Yes	No	Yes	No	Yes	No	Yes	No	High	Low
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										
If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers)										

The list of sample factors in 350-20-35-3C is not all inclusive. Companies should identify any other relevant factors, such as

### Goodwill interim impairment triggers previously included in Topic 350, superseded by ASU 2011-08

Factors	Opposite Condition		Relevant		Entity Specific		Verifiable		Weight	
	Yes	No	Yes	No	Yes	No	Yes	No	High	Low
A significant adverse change in legal factors or in the business climate										
An adverse action or assessment by a regulator										
Unanticipated competition										
A loss of key personnel										
A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of										
The testing for recoverability under the Impairment or Disposal of Long-Lived Assets Subsections of a significant asset group within a reporting unit										

### Long-lived asset impairment triggers in Topic 360

Factors	Opposite Condition		Relevant		Entity Specific		Verifiable		Weight	
	Yes	No	Yes	No	Yes	No	Yes	No	High	Low
A significant decrease in the market price of a long-lived asset (asset group)										
A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition										
A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator										
An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)										
A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)										
A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life										

### Factors considered during the deliberations of EITF Issue 10-A<sup>12</sup>

Factors	Opposite Condition		Relevant		Entity Specific		Verifiable		Weight	
	Yes	No	Yes	No	Yes	No	Yes	No	High	Low
A reporting unit that has a nominal or negative carrying amount.										
A reporting unit that has liabilities whose fair values differs significantly from their carrying amounts.										
A reporting unit whose carrying amount includes deferred taxes and the reporting unit's fair value is based on an assumed taxable transaction structure.										

### Factors related to deferred tax asset impairment in Topic 740

Factors	Opposite Condition		Relevant		Entity Specific		Verifiable		Weight	
	Yes	No	Yes	No	Yes	No	Yes	No	High	Low
A history of operating loss or tax credit carryforwards expiring unused.										
Losses expected in early future years (by a presently profitable entity).										
Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years.										
A carryback, carryforward period that is so brief it would limit realization of tax benefits if a significant deductible temporary difference is expected to reverse in a single year or the entity operates in a traditionally cyclical business.										
Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures										
An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset.										
A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition.										

<sup>12</sup> EITF Issue No. 10-A resulted in ASU No. 2010-18. These factors were briefly considered during the deliberations of Issue 10-A, but ultimately were not included in the FASB Codification.

## Factors from IAS 36, Impairment of Assets

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

### External sources of information

Factors	Opposite Condition		Relevant		Entity Specific		Verifiable		Weight	
	Yes	No	Yes	No	Yes	No	Yes	No	High	Low
During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.										
Significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.										
Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.										
the carrying amount of the net assets of the entity is more than its market capitalization.										

### Internal sources of information

Factors	Opposite Condition		Relevant		Entity Specific		Verifiable		Weight	
	Yes	No	Yes	No	Yes	No	Yes	No	High	Low
evidence is available of obsolescence or physical damage of an asset.										
significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.										
evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.										

*Dividend from a subsidiary, jointly controlled entity or associate*

Factors	Opposite Condition		Relevant		Entity Specific		Verifiable		Weight	
	Yes	No	Yes	No	Yes	No	Yes	No	High	Low
for an investment in a subsidiary, jointly controlled entity or associate, the investor recognizes a dividend from the investment and evidence is available that:										
the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or										
the dividend exceeds the total comprehensive income of the subsidiary, jointly controlled entity or associate in the period the dividend is declared.										

*Evidence from internal reporting that indicates that an asset may be impaired includes the existence of:*

Factors	Opposite Condition		Relevant		Entity Specific		Verifiable		Weight	
	Yes	No	Yes	No	Yes	No	Yes	No	High	Low
cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted;										
actual net cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted;										
a significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset; or										
operating losses or net cash outflows for the asset, when current period amounts are aggregated with budgeted amounts for the future.										

