

ASC 350

Goodwill Impairment Issues



Introduction

This publication is intended to provide a brief summary of potential goodwill and other asset impairment issues under ASC 350 (formerly SFAS 142) that Chief Financial and Accounting Officers, Audit Committee members, and other members of senior management teams should be aware of as 2009 draws to a close. We hope you will find it of interest and instructive as a reference tool in connection with the concepts of ASC 350.

Cove Partners LLC is a fifteen year-old boutique investment bank and financial advisory firm based in San Diego, California focused on providing bulge-bracket quality advisory, valuation, and execution skills and services to the middle-market. We have to date provided services to in excess of one hundred public and privately-held clients in a wide range of diverse industries on a global basis. Our typical client has annual revenues of between \$25 and approximately \$150 million, and our typical publicly-held client has a market capitalization of up to \$250 million. We are principally focused on building long-term relationships with our clients which are designed to help build and monetize shareholder value. While we are headquartered in San Diego, we maintain a global advisory and execution footprint as a result of being the exclusive American representative office of Swiss-based Translink Corporate Finance, a global network of boutique investment banking firms located in 17 countries with a primary focus on cross-border M&A transactions. In its more than twenty-five years of existence, Translink has developed its own proprietary operating procedures to handle a large number of transactions in several countries simultaneously, and offers middle-market clients significant advantages over both large international financial institutions who tend to be more focused on larger transactions, and smaller domestic firms which lack direct coverage and knowledge of foreign countries. In association with our affiliates at Translink, we at Cove Partners would welcome the opportunity to discuss your cross-border M&A needs (either on the buy or sell-side), valuation, or any other financial advisory needs that you may have. Additional information concerning Cove Partners LLC can be found at www.covepartners.com. Information concerning Translink can be found at www.translink-int.com.



Goodwill Impairment and the Current Economic Environment

As the end of the fiscal year approaches for most companies, it is time once again to review issues relating to potential goodwill and other asset impairments under ASC 350 (formerly SFAS 142), which is performed at the reporting unit level rather than at the consolidated entity level. It is required that accounting goodwill be periodically assessed for impairment and if impaired, written down to fair value. In recent times, one of the key questions coming from management teams and audit committees, especially over the course of the last twelve months, is whether the sum of the parts (i.e. the fair value of the aggregate reporting units) must equal the market value of the business enterprise as determined by the share price placed on the consolidated entity by the public marketplace.

Basics of Goodwill

Goodwill is created when an acquisition occurs and the acquiring entity pays total consideration that is in excess of the estimated fair values of the individual assets and liabilities acquired, including intangible assets such as brands, customer relationships, technology, and non-competition agreements, among others. Any excess or residual value is allocated to goodwill under ASC 805 Business Combinations (formerly SFAS 141R). Goodwill in essence represents the unidentifiable intangible benefits from the acquisition, including items such as acquisition related synergies expected to be achieved by the acquirer. In addition, a “control premium” may be present illustrating the enhanced value in owning a controlling ownership position as compared to a minority interest position without benefit of being able to exercise operational control over the acquired business entity.

Impairment Triggers and Declining Stock Prices

ASC 350 requires that goodwill be tested for impairment at least annually. In addition to annual testing, what is less widely known is that ASC 350 also requires potential interim testing, “*if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.*” (¶28 of ASC 350) While ASC 350 lists several examples of events or changed circumstances that might require such an interim test (at ¶28), none of these examples specifically refers to a decline in the stock market value of the company as a trigger for goodwill impairment analysis. Notwithstanding ASC 350’s silence on this issue, several major accounting firms have taken the position that a significant stock price decline may well be considered a “triggering event” which results in a goodwill impairment analysis being required.

This position has been further substantiated directly by the Securities and Exchange Commission (SEC), stating that the need to test for goodwill impairment required judgment and that “*this judgment may be more challenging in the current environment due to recent market declines that indicate that a potential impairment exists.*” It has also been stated that the SEC “*would expect more goodwill impairment than in recent years...*”, suggesting that a “*decline in market capitalization below book value, including the “duration and severity of [the] difference,” would be an impairment testing indicator for goodwill, assuming factors such as short-term volatility are ruled out as the causes.*”

Goodwill Impairment Testing and the Issue of Reconciling the Sum of the Parts to Market Value

Goodwill impairment testing commences with a comparison of the reporting unit’s fair value to its carrying amount. To the extent the fair value does not exceed its carrying amount, there is indication of impairment and the current fair value of the goodwill must be determined. The impairment expense is the difference between the new fair value of goodwill and the carrying amount. When determining the fair value of a reporting unit for impairment testing, ASC 350 states: “*Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity...An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit.*” (¶23 and footnote 16 of ASC 350)

Declining Stock Price May Trigger Impairment Tests and Result in Goodwill Impairment Charges

Although goodwill impairment testing is performed at the reporting unit level, the consolidated entity's market capitalization is often considered relevant, even if not the sole measurement of value, per ASC 350. Given the volatility experienced in the stock market over the past twelve months, it is important to note that notwithstanding the current earnings and/or earnings potential of individual reporting units, there may be an indication of goodwill impairment as a result of a falling parent company share price. This is why the share price declines are likely to lead to an increase in goodwill impairment tests, although a declining share price does not in and of itself necessarily result in a required recognition of impaired goodwill or other assets.

It is extremely important to note that the converse scenario (i.e. a rising market capitalization) does not automatically imply that goodwill is not impaired; as the consolidated parent company's market capitalization (and resultant enterprise value) may be a reflection of over-performing reporting units or an extremely hot vertical market sector while ignoring actual under-performing units, which may still have the potential for goodwill impairment.

The Bottom Line – What it means to you

There is a very clear premise under goodwill impairment testing that the market capitalization of the overall entity must be considered. However, there is no definitive rule mandating the sum of the parts (reporting unit fair values) must reconcile to the market capitalization. That said, it is widely suggested there must be some "reasonable" reconciliation between the two. The SEC is commonly asking management to explain how they took into consideration the fact their stock had been trading at a market value below its book value when determining that their goodwill had not been impaired.

One suggested reason for any variance in the sum of the parts above the current market capitalization is that control premiums associated with a reporting unit are not reflected in the quoted market price of a single share of stock. Control premiums, however, vary widely depending on the nature of the business, industry and market conditions. Therefore, it is strongly encouraged that companies rely upon the assistance of valuation specialists when determining a "reasonable" control premium. In determining the control premium, factors to consider include current market conditions with respect to recent trends in their market capitalization, comparable transactions within the industry, the number of potential buyers, and the availability of financing. Of paramount importance in today's environment, a well-reasoned and thoroughly documented assessment of the control premium value is necessary and the level of supporting evidence in making the assessment is expected to increase as the control premium increases.

Keep in mind, too, that control premiums do play a role in the goodwill impairment analysis of privately-held companies. Multiple approaches should be used in determining the fair value of the reporting unit. Market approaches, based on financial measures of traded public companies, are still based on minority-interest shares and consequently a control premium should be considered when performing the market approach of a privately-held company.

Management is well-advised to carefully monitor industry performance and work closely with a valuation specialist to determine if triggering events have occurred that would suggest the need for interim impairment testing. Whether the annual test or an interim test, goodwill impairment will be under great scrutiny. There is a widespread expectation of significant impairment. Such impairment may also lead to additional impairment testing of long-lived assets under ASC 360.

The current economic environment will affect the outcome of goodwill impairment testing for many companies. Key issues such as the discount rate (cost of capital), control premiums, financial forecasts and underlying assumptions, and historical performance will all play key roles in today's testing environment.

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