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Qualitative Goodwill Impairment Assessment (ASU 2011-08)

Presentation to Institute of Management Accountants
December 20, 2011

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Agenda

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- **Summary of Changes and Key Provisions**
- **Implementation Considerations**
- **Processes and Documentation**
- **Examples**
- **Q&A**

- ***Appendices:***
  - *Goodwill Impairment Steps 1 and 2 – General Framework*
  - *Sample SEC Comments*
  - *Presenter Biography / Contact Information*

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Summary of Changes and Key Provisions

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Background and Highlights of the ASU

- Accounting Standards Update ("ASU") 2011-08, *Testing Goodwill for Impairment*
- Updates provisions in Accounting Standards Codification ("ASC") Topic 350, *Intangibles – Goodwill and Other*
- Issued on September 15, 2011
- Background and Objectives[1]
  - To simplify how entities test goodwill for impairment
  - Preparers of private company financial statements expressed concerns to FASB about the cost and complexity of performing Step 1 of the goodwill impairment test
- **Allows entities to consider qualitative factors prior to performing existing steps of goodwill impairment test**
- Applies to both public and nonpublic entities

[1]*Per Summary in ASU, page 1.*

Summary of Changes and Key Provisions
Effective Date and Transition

- Effective for annual and interim goodwill impairment tests performed **for fiscal years beginning after December 15, 2011**
  - 1 / 2012 for calendar year end companies
- Early adoption permitted
  - For public companies – including tests performed before September 15, 2011, if financial statements not yet issued
  - For private companies – if financial statements not yet issued

[1]*Per Summary in ASU, page 1.*

“Step 0” – At A High Level

“Step 0” Option

- A company can choose to **qualitatively** assess goodwill impairment (“**Step 0**”) before performing Step 1
- Is it **more likely than not** that the Fair Value of a RU < Carrying Amount?

YES

Proceed to Step 1 and Step 2 (if necessary)

ASC 350 Goodwill Impairment -- Step 1

- Determine the Fair Value of RU
- If Fair Value < Carrying Amount, proceed to Step 2

ASC 350 Goodwill Impairment -- Step 2

- Determine implied Fair Value of goodwill based on a hypothetical purchase price allocation (“memo allocation”) as if the RU had been acquired in a business combination

NO

STOP

No further analysis required

“Step 0” – At A High Level (cont.)

- **Flexibility in Step 0 Application**
  - Can apply to one, a combination, or all RUs
  - Can bypass Step 0 for any RU and proceed directly to Step 1
  - Can resume performing Step 0 in any subsequent period
- **No Change to Timing of Impairment Testing**
  - Still on an annual basis
  - Between annual dates if necessary (interim tests – triggering events)
  - Consider when the composition of an RU changes (e.g., disposition or acquisition) and goodwill needs to be reallocated
- **Ability to carry forward prior year fair value estimates eliminated**
  - If a valuation was conducted recently, it should be considered in the Step 0 analysis (“**Baseline Valuation**”)
- **Does not apply to indefinite-lived intangible assets**
  - FASB project currently in progress

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Implementation Considerations

Implementation Considerations
Best Practice Suggestions

Collaboration and consensus among **management, auditors** (both audit and valuation teams), **and external valuation specialists** is key

- ASU does not provide "bright lines"; facts and circumstances-specific
- Qualitative analyses are highly judgmental and subjective; difficult to audit
- Well reasoned approach + high quality documentation needed

Engage in planning discussions as early as possible

☞ ***Example #1***

Implementation Considerations
Importance of Baseline Valuation

- Key consideration for Step 0 Test -- **results of the most recent FV determination (<u>Baseline Valuation</u>)**
  - The amount of excess or **"cushion"** between the RU's FV and carrying value
  - The length of time since the most recent FV determination
    - *"…the more time elapses since an entity last calculated the fair value of a reporting unit, the more difficult it may be to make a conclusion based solely on a qualitative assessment of relevant events and circumstances"*
- Although not required by the standard, consider whether it may be necessary to update the quantitative FV determination
  - Frequency of updates is RU-specific – no "bright lines"

Implementation Considerations
Importance of Baseline Valuation (cont.)

- A Baseline Valuation is key to **both** of the following:
  - Determining **selection of Step 0 option** (or proceeding directly to Step 1)
  - A **factor in a detailed Step 0** test
    - Consider qualitative factors in the ASU (next page) as well as other relevant factors and impact on Baseline Valuation and current RU FV

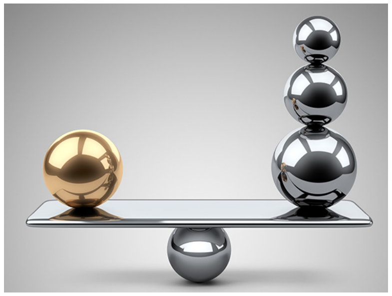
Implementation Considerations
Examples of Step 0 Qualitative Factors

Factor	Examples
▪ **Macroeconomic Conditions**	▪ General economic conditions; access to capital; equity and credit market developments; foreign exchange rate fluctuations
▪ **Industry and Market Conditions**	▪ Deterioration in environment in which entity operates; increased competition; changes in market multiples or metrics of peer companies; regulatory or political developments; changes in demand for a company's products / services
▪ **Cost Factors**	▪ Raw materials, labor, or other costs that impact earnings
▪ **Overall Financial Performance**	▪ Pattern of actual performance (revenue, earnings, and cash flows), as well as a comparison of actual vs. projected results
▪ **Company-Specific Events**	▪ Changes in management, key personnel, strategy, or customers; contemplation of bankruptcy or litigation
▪ **Reporting Unit-Specific Events**	▪ Carrying amount changes, disposal plans, asset group or subsidiary impairment issues
▪ **Share Price**	▪ If applicable, a sustained decrease in share price (both absolute and relative to peers)

Above factors evaluated in conjunction with the most recent Baseline Valuation

Implementation Considerations
Step 0 Qualitative Factors

- Not intended to be all-inclusive
- If adverse factors are identified in Step 0, consider their **significance** relative to the FV of the reporting unit
- Consider **positive and mitigating factors** and events
- Some factors may be **weighted more heavily** than others
- Mitigating factors alone may not preclude the need for a Step 1 analysis



Implementation Considerations
Continuum of Situations – Step 0 or Direct to Step 1?

Step 0 Continuum ← → **Go directly to Step 1**

- Significant cushion – FV vs. Carrying Value in prior Baseline Valuation
- Primarily positive factors

- Medium cushion – FV vs. Carrying Value in prior Baseline Valuation
- Various negative factors, some offsetting factors

- Nominal cushion in last Baseline Valuation
- Significant negative factors
- Entities facing an unfavorable economic environment (per ASU)
- Changes in the composition of a RU due to partial dispositions, acquisitions, or reorganizations

Level of Audit Scrutiny / Required Documentation

Lower → *Higher*

☞ ***Example #2***

Implementation Considerations

Evaluate Changes in RU Financial Performance

- Key financial indicators **vs. last test**
  - Revenue growth
  - Operating margins and profitability
  - Cash flows
- Financial performance **vs. peers**
- Actual results **vs. forecasts**

Implementation Considerations
Evaluate Changes in Market-Based Metrics

- Market capitalization and multiples of peer companies
- Prices of relevant major indices
- *Changes in the above could impact an RU's FV – even if no change in RU operating metrics exist*

Sample Analytical Framework:

Guideline Company	Change in market cap since prior analysis	Index	% change since prior analysis
Comp 1	%	**Dow Jones Industrial Average**	%
Comp 2	%	**NASDAQ 100 Index**	%
Comp 3	%	**Industry-Specific Index**	%
etc.		(e.g., NASDAQ Telecom Index)	
		etc.	

Implementation Considerations
Market Cap Reconciliation – Multiple RUs

- Comparison of sum of RU FVs to total market capitalization as a **reasonableness check**
  - If higher, does total imply a reasonable control premium?
- If not all RUs require Step 1, company can **still consider** whether the summed FV of RUs that required Step 1 is reasonable relative to total market capitalization

Sample Analytical Framework:

	Fair Value	
Reporting Unit #1	$50	
Reporting Unit #2	100	
Reporting Unit #3	20	
Total	**$170**	Implies a 21% control premium
Compares to market cap	***$140***	Reasonable vs. market data?

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Processes & Documentation

- Well reasoned approach + high-quality documentation needed
- Create a **comprehensive matrix** of relevant factors
  - Factors in ASU + other factors, as applicable
  - Assess each factor's impact (positive, neutral, or negative)
  - Weight each factor (low to high) or use a scoring system (e.g., 1 to 5)

Sample Analytical Framework:

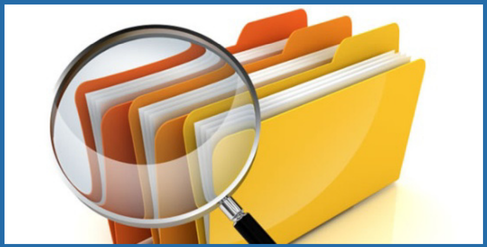
Factor	Negative	Neutral	Positive	Weighting *1 to 5 / NA* *1 = low; 5 = high*	Notes
Industry / competitive environment					
Cost factors					
etc.					

Processes & Documentation
Suggested Practices (cont.)

- Develop **additional documentation** related to
  - Latest Baseline Valuation and cushion
  - Financial performance
  - Market-based metrics
  - Other relevant factors

- Ensure that policies, controls, thought processes, and conclusions related to Step 0 are **well documented**

- Collaboration and consensus among **management, auditors** (both audit and valuation teams), **and external valuation specialists** is key
  - Especially important when process is first established
  - Potential for cost savings



Examples

Examples

EXAMPLE #1

- 8 reporting units
- Assisting with 12/31/11 yearly impairment – company plans to early adopt ASU
- Working in a consultative capacity

EXAMPLE #2

- 3 reporting units
- Reporting units
  - RU #1 – 300% cushion
  - RU #2 – greater than 100% cushion
  - RU #3 – consistently “on the bubble”

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Q & A

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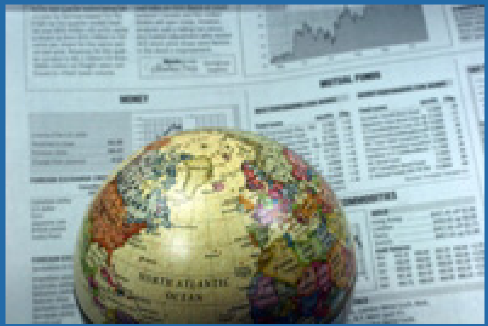
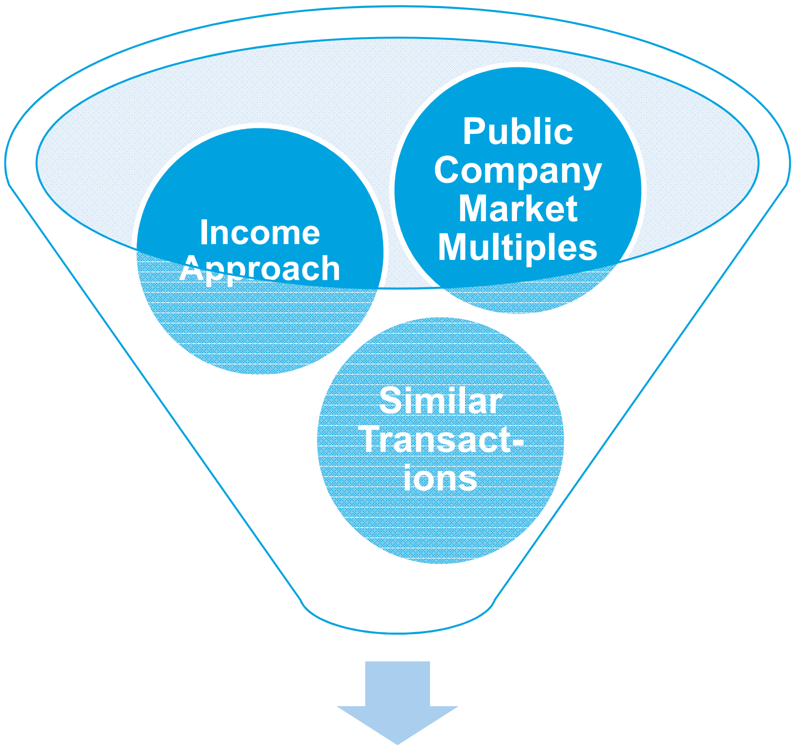


Appendices

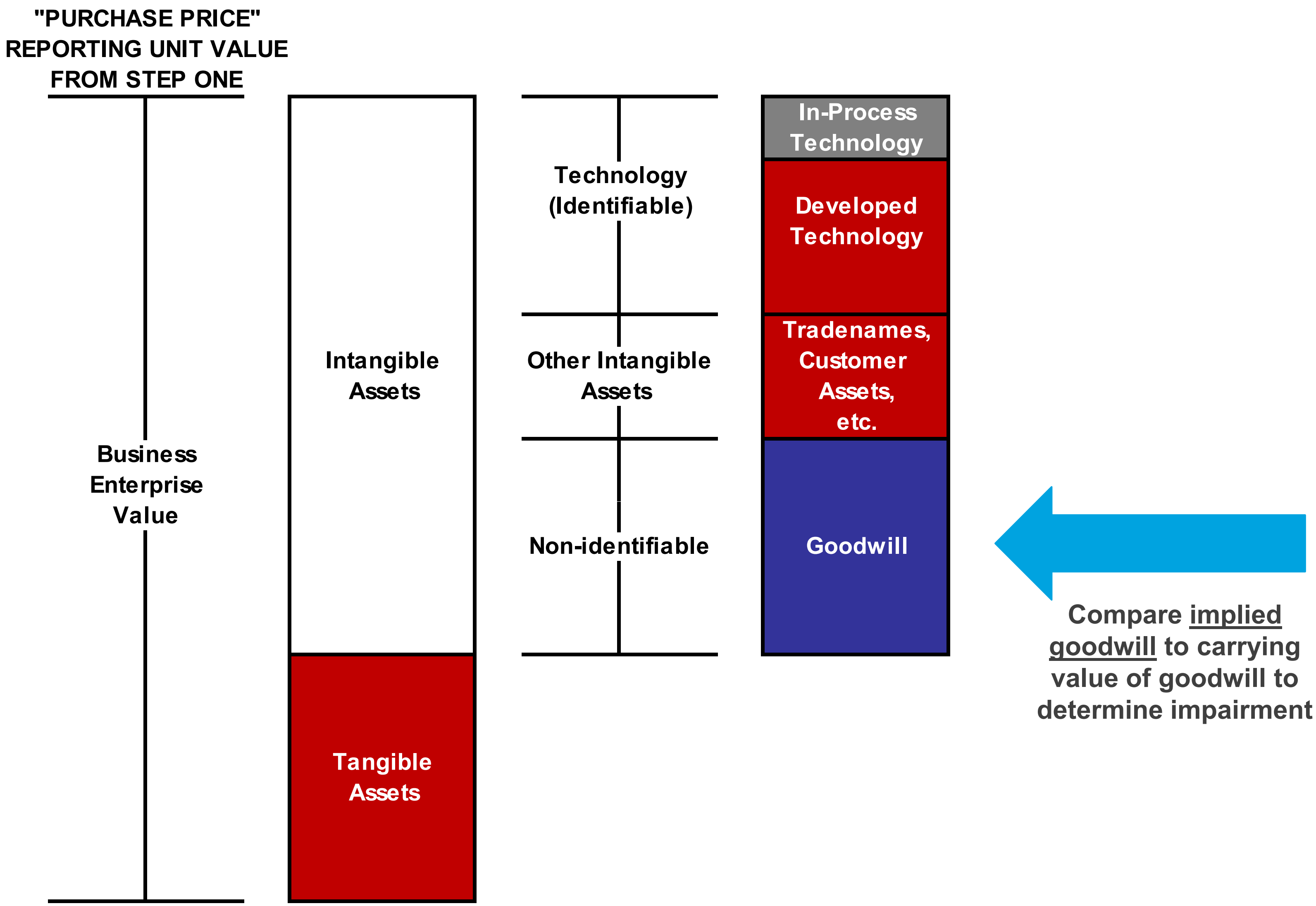
Goodwill Impairment Test -- Step 1
Sample Analytical Framework



Reporting Unit Fair Value

- Compare Fair Value to Carrying Value
- If Fair Value < Carrying Value, proceed to Step 2

Goodwill Impairment Test -- Step 2
Memo Allocation – Overview of Value Components



Sample SEC Comments

- To the extent that any of your reporting units have estimated fair values that are not substantially in excess of their carrying values and goodwill for such reporting units, in the aggregate or individually, if impaired, could materially impact your results or total shareholders' equity, please identify and provide the following disclosures for each such reporting unit in future filings:
  - The percentage by which fair value exceeds carrying value as of the most-recent step-one test.
  - The amount of goodwill allocated to the unit.
  - A description of the material assumptions that drive estimated fair value.
  - A discussion of any uncertainties associated with each key assumption.
  - A discussion of any potential events, trends and/or circumstances that could have a negative effect on estimated fair value.

  If you have determined that estimated fair values substantially exceed the carrying values of your reporting units, please disclose that determination in future filings. Refer to Item 303 of Regulation S-K.

- Considering the materiality of goodwill to your financial statements . . . please tell us and consider expanding future filings to explain in more detail how you determine your reporting units for purposes of your goodwill impairment tests. In your response, please tell us each of your reporting units, the amount of goodwill allocated to each reporting unit, and to the extent that any components have been aggregated, the basis for such aggregation.

Speaker Background / Contact Information

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Current Responsibilities

Josette Ferrer is the founder and a Managing Director of Clairent Advisors. Since 1993, Josette has been assisting clients with the valuation of closely held businesses and business interests, intangible assets, intellectual property, stock options, debt instruments, capital equipment / fixed assets, and other assets.

Experience

Prior to founding Clairent Advisors in 2010, Josette was the U.S. Practice Leader of Marsh's Valuation Services Group (formerly Kroll's Valuation Services Practice). Her career includes serving as the Managing Director in charge of the San Francisco Valuation Services Group of WTAS, Inc. ("WTAS"), a former subsidiary of HSBC Group. At WTAS, Josette's responsibilities included developing and overseeing all technical, operational, marketing functions for the SF valuation team. Prior to WTAS, Josette was a director with Huron Consulting Group and a senior manager at Arthur Andersen LLP.

While Josette has extensive experience serving clients in many industries, areas of specialty include telecommunications, high technology, service companies, consumer products, manufacturing, and financial services. Her clients have ranged from small, emerging businesses to Fortune 500 companies. Josette has been a guest speaker for a wide variety of forums, including Financial Executives International (“FEI”), the Institute of Management Accountants (“IMA”), the Practicing Law Institute (“PLI”), the San Francisco Bar Association, Santa Clara University, BIOCOM, and various venture capital roundtables, and has also published an article related to the valuation of intellectual property for the PLI.

Education and Affiliations

- B.S. in Business Administration, University of California, Berkeley
- Fair Value Forum
- Financial Executives International
- American Society of Appraisers
- ProVisors