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Valuation Issues in the Coming Wave of Goodwill and Asset Impairments

By Bala G. Dharan, Ph.D., CPA

Widespread stock price declines and recessionary conditions will significantly affect corporate valuation and financial reporting of goodwill and long-term assets. The S&P 500 index, which represents a broad cross-section of the economy, declined by about 38.5 percent in 2008—its worst performance since 1937—and the stock market fell another 15 percent in the first two months of 2009. While the financial sector represented in the S&P 500 index declined the most in this period, all ten sectors represented registered significant double-digit declines.

Accounting standard FAS 144[1] requires companies to periodically assess the fair value of long-term assets and take impairment charges to the extent the fair value decline is considered other than temporary. In addition, FAS 142[2] requires that accounting goodwill be periodically assessed for impairment and written down to fair value. Since these standards require a fair value assessment, they are covered by the fair value disclosure standard FAS 157.[3] FAS 157 defines fair value as the price at which an asset can be sold or a liability can be settled, and requires that the valuation process used by the company reflect market participants' views. This means that valuation model inputs, such as cash flow projections, cost of capital, and discount rates, should incorporate current market conditions and market participants' views.

Similarly, market-related data used for valuation procedures, such as the guideline public company method or guideline transaction method, should reflect current market conditions and market participants' views.

Given the widespread stock price declines and the deepening recession, it is not surprising

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Fair Value Accounting & Litigation: The Next Wave of Valuation Risk

By Antonio Yanez Jr.

Some blame fair value accounting requirements for aggravating the economic downturn by requiring write-downs that exaggerate asset value declines. Others say that fair value accounting is the best method of recording asset values and that to blunt the effects of fair value accounting requirements would simply prolong the problem.

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that several companies have in recent weeks announced large write-downs of goodwill, intangible assets, and other assets. Recent corporate announcements of multi-billion dollar goodwill and asset write-offs include Time Warner ($25 billion), ConocoPhillips ($35 billion), Regions Financial ($6 billion), and Royal Bank of Scotland ($33 billion[4]). One should expect to see more such announcements of asset write-offs in the coming weeks and months. Goodwill is particularly vulnerable to large write-offs. Because of the wave of mergers and acquisitions that started in the late 1990s, goodwill is now a large percentage of the total assets of many corporations, so goodwill write-offs, when they occur, can be significant. In general, technology, media, energy, and consumer products companies tend to have large goodwill accounts due to industry consolidations and acquisition activities. For some technology companies, such as Cisco Systems, Inc., goodwill is the largest non-current asset on the balance sheet.

According to a research report cited by *The Economist*, goodwill in corporate balance sheets totals about $2.6 trillion.[5] A large portion of this goodwill undoubtedly resulted from mergers and acquisitions completed at the height of the stock market valuation in the 2004-2007 period. These transaction valuations have to be reassessed given the stock market decline and the recession's effect on projected cash flows. It is easy to see that the resulting goodwill write-off may add up to several hundreds of billions of dollars, rivaling in magnitude the initial wave of 2008 losses recognized from mortgage-related assets.

If history is any guide, we may also see several lawsuits against companies—and their advisors—following the asset impairment announcements related to the amount and the timing of these impairment charges as well as the alleged damages based on stock price declines. A late-2008 impairment announcement by CBS Corporation provides an illustration. During 2008, the stock price of CBS declined considerably, falling almost 50 percent by September 30, 2008.[6] On October 10, 2008, the company announced that "as a result of adverse market conditions," it conducted an impairment analysis of goodwill and intangible assets that resulted in a goodwill write-off of about $9.6 billion and an additional write-off of about $4.6 billion in other intangible assets. In December 2008, a purported class action lawsuit was filed against the company alleging, among others, the "failure to timely write-down impaired intangible and goodwill assets."

Goodwill write-offs and stock price declines. For goodwill and other non-financial assets, the purpose of periodic fair value evaluation is to determine whether "impairment" in the value of the asset has occurred, i.e., whether the fair value of the asset is less than the asset's balance sheet "carrying value." If the fair value evaluation suggests that an "other than temporary" impairment of fair value has occurred, then the company must write-down the carrying value of the asset on the balance sheet to the estimated fair value and recognize a corresponding impairment charge (loss) in its income statement. Factors considered for tests of impairment vary by the type of asset evaluated. In testing the goodwill asset for impairment, the market capitalization of the firm is often considered relevant. This is why the recent stock price declines are likely to lead to an increase in goodwill impairment tests, although a falling stock price is neither necessary nor sufficient for the recognition of impairment of goodwill or other assets.

To understand why stock price declines could precipitate a goodwill impairment test, it is useful to review the accounting basics for goodwill recognition and write-off. The goodwill account on the balance sheet is created when a firm acquires another firm or its assets and liabilities for a price that is in excess of the estimated fair values of the individual assets and liabilities acquired. FAS 142 requires that fair values are first determined at the so-called reporting unit level for all identifiable assets and liabilities acquired, including acquired intangible assets such as brands, royalties, and copyrights. Goodwill is then the excess of the price paid over the fair values of all identifiable assets less liabilities acquired.

Goodwill thus essentially represents unidentifiable intangible benefits from acquisition. For example, FAS 142 suggests that goodwill may be due to, among others, the "control premium" over fair values that a buyer would pay to get acquisition-related synergies. FAS 142 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."[7]

Impairment and consideration of stock prices. FAS 142, of course, requires that goodwill, once created, should be carried indefinitely at its original value without amortization unless an impairment analysis of the fair value of the reporting unit level indicates that goodwill has been impaired. Such a test for goodwill impairment must be done at least annually and also in the interim between annual tests "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."[8]

FAS 142 lists several examples of events or changed circumstances that might require an interim test for goodwill impairment. Although none of these examples specifically refers to a decline in the stock market value of the company as a trigger for goodwill impairment analysis, major accounting firms have stated that a significant stock price decline may be a potential event or changed circumstance requiring an impairment analysis for goodwill. For example, an Ernst & Young publication dated October 2008 states: "A significant decline in a company's stock price may suggest that the fair value of one or more reporting units has fallen below their carrying amounts. Similarly, declines in the stock prices of other companies in a reporting unit's industry may suggest that an interim test for goodwill impairment is required."[9] Similar comments on the potential for goodwill write-offs due to recent stock price declines have been included in recent publications by other major accounting firms.[10]

The SEC's view on stock price decline and goodwill impairment. The Securities and Exchange Commission (SEC) has also said that it expects more goodwill impairment than usual due to the recent declines in stock prices. Robert Fox, III, a Professional Accounting Fellow at the SEC, said at a recent accounting conference 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."[11] He added that the SEC "would expect more goodwill impairment than in recent years..." in the upcoming financial filings.

At the same conference, Steven Jacobs, an Associate Chief Accountant at the SEC, indicated that a "decline in market capitalization below book value," including the "duration and severity of [the] difference,"[12] would be an impairment testing indicator for goodwill, assuming factors such as short-term volatility are ruled out as the causes. More interestingly, Mr. Jacobs noted that even in cases where a current impairment charge of goodwill is not taken, companies may be required to provide "early warning disclosures" of potential future goodwill impairment charges if there is a reasonable possibility of loss. These remarks by SEC staff members suggest that the SEC would be looking for an explanation from corporations on how they considered current stock price declines when analyzing goodwill impairment.

The SEC staff appears to have already made these kinds of inquiries during 2008 in some of its "comment letters" sent to companies requesting clarifications related to their 10-K and 10-Q filings. For example, in a comment letter to Regions Financial Corporation dated June 17, 2008, the SEC staff asked the company to explain, "How you determined that your goodwill balance is not impaired. Please specifically address how you took into consideration the fact that you have been trading at a market value that is below your book value."[13] The company, in its reply filed on July 1, 2008, responded that, "management could not conclude that [lower market value] was a long-term trend, particularly when our stock price was trading above book value in the fourth quarter of 2007. Further, given the relatively small difference between our stock price and our book value per share, we determined that a potential buyer would offer a control premium for our business franchise that would adequately cover these differences between trading prices and book values."

As Regions Financial explained, a commonly claimed mitigating factor when the market value of a company is below its book value is whether the goodwill on the balance sheet represents (or may be justified by) the control premium that a current buyer would pay for the company. Clearly, there is judgment involved in determining the amount of control premium for a reporting unit. However, the SEC's Fox, the speaker at the above-mentioned AICPA national conference, cautioned that companies should be prepared to justify the assumptions of control premiums that current buyers would pay given the significant fall in stock prices last year. Fox said, "I would also note that the amount of supporting evidence supporting your judgment would likely be expected to increase as any control premium increases."

Valuation and economic effects. Goodwill and asset impairment charges are generally considered "non-cash" in nature, i.e., they affect earnings but not cash flows from operations. Nevertheless, there may be stock price effects from goodwill announcements depending on the extent to which the information is a surprise to the market. In addition, stock price effects will also depend on whether the impairment charges could affect a company's future operations and cash flows.

The effect on cash flows is hard to predict, and it would depend on how the impairments—and the resulting earnings decline—affect the company's loan covenants, employment agreements, compensation plans, etc. Goodwill and asset impairment will also affect several financial ratios used in loan covenants and used by financial analysts to evaluate risk and returns. For example, large goodwill or other asset impairments would increase the debt-equity ratio and could cause violations of some ratio-based loan covenants. There could also be analyst rating changes and credit rating changes that could increase the cost of borrowing. Earn-out contracts and contingency payments related to mergers and acquisitions could be dependent on reported earnings, which could affect the cash flows related to these contracts. Valuation specialists and accountants need to consider these potential effects in evaluating the possible valuation consequences of goodwill and asset impairment.

About the author: Bala Dharan is a vice president in the financial accounting and valuation group at CRA International, Inc., a global business, financial and economic consulting firm. Dharan is also a visiting professor of accounting at Harvard Law School.

1. Statement of Financial Reporting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," Financial Accounting Standards Board, August 2001, as amended. The corresponding International Financial Reporting Standard (IFRS) 5, "Non-current Assets Held for Sale and Discontinued Operations," International Accounting Standards Board, is similar to FAS 144.
2. Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets," Financial Accounting Standards Board, June 2001, as amended. The corresponding international financial reporting standard is similar. See IAS 36, "Impairment of Assets," International Accounting Standards Board.