

## Step Zero Qualitative Goodwill Testing

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## OBJECTIVES

- Understand the genesis of the qualitative testing
- Understand the “nuts and bolts” of qualitative testing
- Observe current trends in practice and observe best practices
- Enhance knowledge through examples and discussion among peers



## Agenda

- Overview of how we got here
- Understanding the guidance
- Application Framework
- Current trends in practice
- Case studies
- Questions

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## How did we get here?

- FASB conducted private company roundtables in October and November 2010
- Concerns were raised over the recurring cost and complexity over calculating the fair value of a reporting unit under step 1 of ASC 350
- Preparers raised the notion of allowing entities to use a qualitative approach to test goodwill for impairment
- Others asked the Board to consider whether there was a basis for allowing different treatment for public v. non-public entities



## How did we get here?

- Additional input from the Private Company Financial Reporting Committee (PCFRC) via its comment letter on EITF Issue 10-A
  - Recommended that Board consider allowing all non-public entities to use qualitative approach
- December 2010 – FASB added the project to the agenda
- April 2011 – Exposure Draft
- December 2011 - Issued ASU 2011-08



## Basis for Conclusion Insights

- Many accounting firms expressed concerns over the ability to audit a qualitative test causing a variation in how some companies may analyze their specific facts and circumstances
- No prescriptive guidance or examples available
- Board noted that this ASU does not advance the convergence of US GAAP and IFRS
- Considered modifying the 'substantial margin' language in ASC 350 – later to scrap it altogether



## Basis for Conclusion Insights (Cont.)

- Considered a proposed amortization models
- Considered de-recognition and immediate write off of newly acquired goodwill

*Ultimately these (and a few others) were dismissed*



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## Understanding the Guidance

### Basics:

- Effective for fiscal years beginning after December 15, 2011, early adoption permitted
- An entity **may** assess qualitative factors to determine whether or not that the fair value of a reporting unit is less than its carrying amount, including goodwill
- Entities have an **unconditional option to bypass** the qualitative assessment for **any** reporting unit
- Entities may resume performing the qualitative test in any subsequent period
- More-likely-than-not criteria, greater than 50%

## Understanding the Guidance

- List provided in ASC 350-20-35-3C is not all-inclusive so additional guidance provided:
  - Consider other relevant factors and their potential impact of the FV of the RU
  - Place more weight on those items that most affect the FV
  - Consider positive or other mitigating factors
  - Consider the latest fair value determination and the related cushion

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## Application Framework

1. Identify relevant drivers of value
2. Identify relevant events and circumstances that may have an impact on value drivers
3. Weight the events and circumstances
4. Conclude on the totality of events and circumstances

## Application Framework

### *Value Drivers – a closer look*

- Economic Metric
- Growth
- Risk
- Horizon

Most approaches, techniques and models boil down to these four simple factors

## Application Framework

### 1. *Identify relevant drivers of value (ASC 350-20-35-3C)*

- Key inputs or assumptions that **most** affect fair value
- Useful to assess in the context of latest quantitative analysis completed for the RU
  - Growth assumptions
  - Discount rate assumptions
  - Magnitude of multiples applied
- Consider weightings applied to different approaches and/or techniques
- Remember, market participant standard is in play



## Application Framework

### 2. *Identify relevant events and circumstances that may have an impact on value drivers*

- **Macroeconomic conditions**- access to capital markets, FX fluctuations or other developments in crest or equity markets
- **Industry and market conditions**- deteriorating environment, increased competition, decline in multiples or metrics, change in the market for products or services, regulatory or political development
- **Cost factors** – increases in raw material, labor or other costs that have a negative effect on earnings and cash flows



## Application Framework

2. *Identify relevant events and circumstances that may have an impact on value drivers*
  - **Overall financial performance** – negative or declining cash flows, decline in actual or planned revenue compared with budget and actual
  - **Other relevant entity specific events** – changes in management, key personnel, strategy or customers; contemplation of bankruptcy
  - **Events affecting a reporting unit** – change in composition or carrying amounts of RU's, anticipated dispositions, recoverability tests
  - **Sustained decrease in share price** (if applicable)



## Application Framework

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## Application Framework

2. *Identify relevant events and circumstances that may have an impact on value drivers – Additional Items to consider*
  - **Market reaction to a new product**
  - **Technological obsolescence of a product**
  - **Significant legal development**
  - **Liquidation of RU or a portion of RU**

***Remember to also consider positive and mitigating factors***



## Application Framework

2. *Identify relevant events and circumstances that may have an impact on value drivers – Additional Items to consider*
  - **Recent Fair Value Calculations –**
    - Consider the amount of 'cushion' implied in last quantitative analysis as a factor
    - The larger the cushion, the more potential that qualitative assessment is appropriate, all else equal
    - Consider the shelf life of last analysis and any adverse changes that may have occurred since that date
    - Periodic re-measurement appears to be an emerging best practice



## Application Framework

2. *Identify relevant events and circumstances that may have an impact on value drivers – Additional Items to consider*
  - **Changes in composition of a RU or a change in carrying amount –**
    - May render prior quantitative analysis void
    - May make the qualitative analysis more difficult

## Application Framework

3. *Weight the events and circumstances (ASC 350-20-35-3F)*
  - Consider the extent to which adverse event identified could affect comparison of RU fair value to carrying amount
  - More weight on those that most affect fair value or carrying amount
  - Some events could impact different RU's in different ways or magnitude – be careful with broad generalizations
  - Existence of positive or mitigating factors is not intended to represent a rebuttable presumption that qualitative test can be satisfied

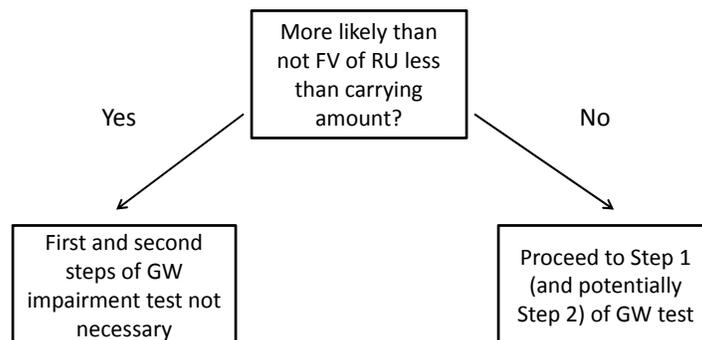
## Application Framework

3. *Weight the events and circumstances (ASC 350-20-35-3F)*
  - All available evidence, both positive and negative, should be considered and weighed in determining whether it is more likely than not that the fair value of the RU is less than its carrying amount
  - Weighting requires application of judgment
  - Weighting applied (whether positive or negative evidence) should be commensurate with the extent to which it can be supported objectively



## Application Framework

4. *Conclude on the totality of events and circumstances*



## Application Framework

4. *Conclude on the totality of events and circumstances*
  - **Extent of analysis** – complexity and extensiveness of analysis will vary based on facts and circumstances. There is no 'one size fits all' tool
  - **Example** – the qualitative assessment may need to be more robust and extensive if a more time elapses since its last quantitative measurement
  - **If qualitative test is satisfied** – entity needs to make a positive assertion about conclusion reached and why. This assertion needs to be supported appropriate and relevant evidence
  - **Only document positive assertions** – if moving to Step 1, no documentation needed as it will be captured in the valuation of the reporting unit. Also, no de facto failure of Step 1



## Application Framework

### *Other Considerations*

- **Prior carryover provisions superseded** – the positive assertion is distinct from prior carryover election (which was superseded in the ASU)
- **Compared to interim evaluation under ASC 350** – analysis for whether a trigger event has occurred is a separate and distinct analysis that looks only to adverse events and circumstances. Qualitative test considers both positive and negative events and circumstances



## Application Framework

### *Other Considerations*

- **Market Cap reconciliation process** – still a meaningful analytic but may be more difficult to perform and document:
  - Seek to short cut a quantitative output for the reporting unit(s) that reflect a positive assertion under qualitative testing
    - Carrying value plus last cushion
    - Last quantitative measurement adjusted for events occurring since then
  - Judgment will be more critical
  - Documentation important for the external audit

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## Current trends in practice

- Implicit challenges
  - First time exposure this past audit season
  - No prescriptive guidance
  - High level of judgment applied
  - No specific requirement for measurement, however.....
  - RU treatment split between qualitative and quantitative

## Current trends in practice

- General Observations
  - Very popular election in some cases
  - Preparers are searching for the "best mouse trap"
  - Tendency to over rely on internal factors
  - Auditing these assertions have challenges
  - Public registrants sometimes ignore this option
  - Interest in establishing 'baseline' measurements
  - Shelf life of cushions not bright lined
  - Magnitude of cushion issues – how much is enough?

## Current trends in practice

- Best Practices Observations
  - Companies establish a process and framework that can be consistently applied
  - Audit firms still involve their own valuation specialists to vet the inputs that management relies on
  - Management prepared analyses still consult with outside specialists
  - Documentation
  - Shelf life of cushions not bright lined
  - Magnitude of cushion issues – how much is enough?



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## EXAMPLE 1

### *Summary Facts – Company A (Public Registrant)*

- Food and beverage industry
- Three RU's (RU1 (Energy Drinks), RU2 (Energy Foods), RU3 (Flavored Water); corporate entity with no goodwill
- Local, regional, and national channels
- Annual test date October 1
- All have positive carrying amounts
- All had quantitative tests completed in prior year
- All are being considered for qualitative screening



## EXAMPLE 1 (Cont.)

Reporting Unit	PY Cushion
RU 1	21%
RU 2	8%
RU 3	19%
Corporate	N/A



## EXAMPLE 1 (Cont.)

### *Events and Circumstances - General*

- Poor macro trends, GDP growth rates underperforming expectations (2% v. expected 3%)
- Co. A share price up a little, peer group prices relatively flat
- Market cap slightly higher, exceed aggregate carrying amount by 30%
- Interest rates and borrowing costs are stable YOY



## EXAMPLE 1 (Cont.)

### *Events and Circumstances – Specific to RU 1*

- RU1 growth higher than expected due to increased demand (8% v. expected 5%)
- Industry is becoming more competitive with new entrants
- Market share increased by 2%
- FX rates hurt margins less than 1% due to sourcing of inputs
- Operating expenses stable and predictable
- Gross margins exceeded expectation by 4%
- EBITDA growth of 8% v. 4% expected. Peers grew at 4%
- Peer multiples were flat YOY
- No significant changes in carrying amount or composition of RU 1



## EXAMPLE 1 (Cont.)

Can RU 1 make a positive assertion that it is not more likely than not that the fair value of the RU is not less than its carrying amount?

*How do you support this position?*

## Example 1 - Solution

- Management will make a positive assertion for RU 1
  - Cushion in prior year, no significant changes to carrying amount
  - Exceeding growth expectations, internal and external
  - Increased market share despite new entrants
  - Capital markets environment fairly stable
  - Operating expense structure stable

## Example 1 – Solution (Cont.)

- Management will make a positive assertion for RU 1
  - Negative events and circumstances would not have significant impact on fair value and are mitigated largely by positive events and circumstances
    - GDP growth is off but apparently not impacting the company
    - FX environment is unfavorable but mitigated

## EXAMPLE 2

### *Events and Circumstances – Specific to RU 2*

- Several new competitors have entered the market
- Market share declined by 3% when expectations were that it would retain steady market share
- Revenues decreased YOY by 4% when management's forecast from prior year reflected 2% growth
- No significant changes in carrying amount
- Margins were slightly off expectations

## EXAMPLE 2 - Solution

- Management should proceed to Step 1
  - Although the negative events and circumstances do not appear to be mitigated by positive ones, this is not a prima facie indication that RU 2 would fail Step 1 –
  - Cushion of 8% not viewed as sufficient to save the day
  - Step 1 should be performed per ASC 350
  - This unit may consider qualitative testing in the future if conditions improve

## EXAMPLE 3

### *Events and Circumstances – Specific to RU 3*

- Market is maturing, demand may be leveling off
- Market is still reflecting new competition
- Revenue grew 2% versus expectation of 4%
- Gross margin and EBITDA were flat, consistent with expectations
- Implied multiples from peer group were lower than PY
- Operational improvements were implemented as planned and completed in CY – slight improvement to margin is anticipated going forward

## EXAMPLE 3

### *Events and Circumstances – Specific to RU 3 (Cont.)*

- Recent lawsuit was filed against RU 3 claiming patent infringement. RU 3 will vigorously defend the case and believes an unfavorable outcome is not likely. No accrual reflected in the F/S. Potential damages claim is a royalty of 1% of future revenues
- Carrying amount is slightly higher due to capitalized costs associated with operational improvements



## EXAMPLE 3 - Solution

- Qualitative assessment is applied, positive assertion cannot be made
  - Negative events and circumstances have large potential impact on fair value and in the aggregate are not mitigated by positive factors
    - Poor GDP performance
    - Flat margins on declining revenue base
    - Mature market
    - Decline in peer pricing
    - Potential lawsuit
  - Cushion of 19% is helpful, but not sufficient to offset negative events and circumstances
  - Step 1 should be performed per ASC 350
  - This unit may consider qualitative testing in the future if conditions improve



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