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Mergers & Acquisitions —A snapshot

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Highlights

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- **Revisiting the goodwill impairment testing framework**
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Goodwill impairment testing: What's old is new again

The role of fair value in financial reporting has been a hot topic for some time. Much of the debate has generally focused on financial instruments. However, with the credit crisis spreading to the general economy, impairment testing for non-financial assets has taken center stage. This is particularly true for historically acquisitive companies that have significant amounts of recorded goodwill on their balance sheets, regardless of industry.

Since the adoption of FAS 142, the goodwill impairment standard, the equity markets have generally trended upward. Accordingly, impairments may not have been as frequent as we expect to see them today.

This edition of *Mergers & Acquisitions—A snapshot,* focuses on some of the issues companies may face in preparing goodwill impairment tests in the current environment. It also serves as a refresher on certain aspects of the framework for conducting those tests. Application of the standard can be challenging, and judgments surrounding key assumptions will be critical in assessing goodwill for impairment. Companies may therefore find it helpful to begin the process as early as possible and seek accounting and valuation assistance where needed.

Revisiting the goodwill impairment testing framework

It's not necessarily just once per year.

At a minimum, goodwill impairment testing should be done annually. It should also occur between annual testing dates if events suggest that the fair value of the business to be tested—referred to as a reporting unit—is below the unit's carrying amount.

The market downturn has impacted most entities in some way. For example, given the volatile capital markets today, one common "triggering event" stems from publicly traded companies' equity shares trading below their book value. There are no hard and fast rules for the length of time required for such a situation to give rise to a triggering event. On the one hand, if a company's public equity trades below book value for only a few days, a triggering event likely has not occurred. On the other hand, if the company's public equity trades below its book value for a sustained period of time, a triggering event has likely occurred.

If events suggest that the fair value of a reporting unit is below its carrying amount, companies should consider whether an interim impairment test is necessary.

The sum of the parts should reconcile.

For a public entity, the company's overall market capitalization should reconcile, within a reasonable range, to the sum of the equity fair values for the individual reporting units. This is one of the few available means of ascertaining whether a company's aggregated estimated equity values for its reporting units are calibrated to the public market.

To ignore the market value, or to simply assert that the quoted market price does not reflect fair value, is not advisable. Implicit in a public company's equity price is the daily fair value assessment of its parts. That price should therefore be considered in a goodwill impairment test.

However, there are usually differences between the aggregate fair value of the reporting units and the company's overall market capitalization. This typically results from control premiums that are not reflected in the quoted market price of a single share of stock. Other differences, such as a discrepancy between the reporting units' aggregate fair value and a given daily market capitalization that isn't representative of fair value, should also be considered.

Implied control premiums should be supportable within a reasonable range. There is no rule of thumb for an acceptable range of control premiums. In today's environment it may be especially difficult to determine a reasonable range of control premiums based on recent transactions. It is also important to remember that such premiums apply to equity only, not to the overall enterprise value (equity plus debt capital) of the reporting units.

More is better.

Companies often perform their goodwill impairment test by using a discounted cash flow approach, since active public markets usually do not exist at the reporting unit level. However, valuation is an art, not a science, and therefore management should consider the use of multiple valuation approaches in determining the fair value of a reporting unit. Those approaches may include discounted cash flow analyses and market-based approaches (e.g., an analysis of public trading multiples and comparable transaction multiples), as well as the reconciliation of the aggregate fair value of a company's reporting units to the entity's overall public market capitalization.

A market participant view is paramount.

Cash flow forecasts developed for impairment testing should consider cash flows that are achievable by a market participant. Market participants are defined as knowledgeable, able, and willing buyers and sellers in the principal (or most advantageous) market for a given asset.

For example, even if management believes it can guide a particular reporting unit through current economic conditions without significant operational impact, the assessment of fair value should be made from the perspective of a market participant. This should include consideration of how the market participant expects the reporting unit to perform. That view may impact a number of assumptions employed within cash flow projections, including revenue growth, profit margins, long-term growth rates, discount rates and risk premiums used in cash flow projections.

Follow the rules.

The first step in the goodwill impairment test is to assess whether a reporting unit's fair value is less than the unit's carrying amount. If this is the case, the second step is to measure the amount of any goodwill impairment. Since goodwill is by definition a residual, the implied value of goodwill is determined by revaluing all tangible and intangible assets, as well as liabilities, and then subtracting this net asset value from the fair value of the reporting unit. (If the fair value of a reporting unit is greater than the unit's carrying amount in the first step, or if the implied value of goodwill is greater than its recorded amount in the second step, a company does not record a goodwill impairment).

Impairment testing on all other accounts, and any resulting write-downs, must be performed before testing goodwill. Just as goodwill impairment testing has its own prescriptive framework, most other asset categories do as well, particularly long-lived assets such as fixed assets and intangible assets. Only after the results of all other impairment tests have been considered can the company determine the carrying amount of its reporting units.

When performing the goodwill impairment test, companies should consider whether the fair value of the reporting unit can be maximized, from a market participant perspective, through a nontaxable or taxable transaction. In either scenario, it is likely that the deferred taxes attributable to the reporting unit in the first step (actual deferred tax balances) would be different in the second step (based on a current hypothetical transaction). Accordingly, simply carrying forward actual deferred tax balances to the second step may not be appropriate.

Lastly, the second step is not just a revaluation of the identifiable intangible assets already on the books. It is a full valuation of the reporting unit's assets and liabilities, conducted as though the unit were a newly acquired business (i.e., a purchase price allocation), which entails valuing items that might not already be held at fair value, such as inventory, fixed assets and debt, as well as any "home grown" intangible assets not currently recorded on the company's books. This purchase price allocation is performed only in assessing goodwill for impairment, and does not change the recognition or measurement of these assets and liabilities in the financial statements.

Assessing recent developments

Market values are still critical.

The FASB recently provided guidance on estimating the fair value of financial assets that trade in inactive markets. In those cases, companies should consider cash flow-based valuation techniques only when no relevant observable inputs exist. However, for most public companies with exchange-traded stock, there are likely to be relevant observable inputs for reconciling the aggregate fair value of reporting units' equity to the company's market capitalization.

"My cash flow forecasts are not affected by current market events." Not so fast!

As economists lower their estimates of forecasted domestic and global macroeconomic growth in light of current market events, companies should consider how those events might similarly impact their forecasts of near- and long-term cash flows. There may be heightened uncertainty about the amount and/or timing of cash flows, particularly for industries in which customer purchases are discretionary. Further, rapidly changing markets may indicate that cash flow projections need to be revisited frequently.

Higher required rates of return may apply.

The current financial crisis has likely led to increased risks to investors that may need to be considered in determining the rates of return used in income-based valuations. In determining the appropriate rates of return, discount rates should be scrutinized and may need to be adjusted from prior year's testing for several reasons. These reasons include:

- Various macroeconomic and industry risks might not have been factored into original cash flow forecasts. Such risks can be captured by adjusting the discount rates used in the forecasts.
- Capital structures may have shifted. If creditors remain reluctant to lend, there is the possibility that capital structures will migrate to a higher equity weighting, which tends to carry a higher risk premium.
- Given the current credit environment, borrowing costs have increased for many companies across a broad spectrum of industries.
- Investors may require a higher rate of return at a given level of risk for holding equities.

Implied control premiums are generating considerable discussion.

One of the biggest impairment issues in the current environment relates to the size of implied control premiums when reconciling the aggregate fair values of individual reporting units to the company's overall market capitalization. Some argue that in our current down market, the value of control premiums should increase. There are a few important points to bear in mind here:

- First, there is presumably a widening gap between (1) what buyers are now willing to pay for a reporting unit as they try to take advantage of prices that reflect current market conditions and (2) what sellers are willing to accept. By and large, sellers remain convinced that their reporting units are worth more than the current market value (their logic being that they wouldn't sell their business at current market value). This stance might work for top companies in certain sectors, particularly if demand for the purchase of their businesses remains high. For many companies, however, bids might not emerge beyond current market values, suggesting that control premiums do not automatically trend upward. Remember that there needs to be a willing buyer to support a given level of control premium.
- Second, discounted cash flow analyses are typically based on the assumption that there is a liquid market for the reporting units. In the current environment, management may need to consider applying liquidity discounts to the reporting units' equity values to reflect the difficulty of selling the businesses in the current market. Potential buyers' access to financing may be severely limited, except in the case of buyers with extremely strong credit ratings in industries less affected by the current economic crisis and in the case of buyers holding excess cash who are willing to spend it.
- Companies may find that their initial goodwill impairment analysis suggests a sizable premium over the market capitalization of the whole company. Without such large implied control premiums, companies may face potential goodwill impairments. An implied level of control premium that is unusually high should be a red flag, signaling the need to critically assess how well the reporting units are holding up in the current environment, as well as the likelihood of finding that "willing buyer."

Public debt prices might not tell the whole story.

In the current market, many public debt securities trade at a discount to par, suggesting an even greater percentage discount for equities that are junior to debt in the capital structure. However, we may witness situations in which the fair value of a company's debt has declined disproportionately to the fair value of its equity.

For example, before the current credit crisis, certain entities were able to issue debt instruments featuring very few covenants and other protections for the bond holders, and at rates that did not compensate the holders for that lack of protection. Currently, many such instruments, with disadvantageous terms to the holders, are trading at deep discounts because of their subordinate position in the capital structure and not necessarily due to underlying operational difficulties within the business itself. It is possible, therefore, that deep discounts on public debt reflect more than simply operational issues in the underlying business. As a result, this debt may experience more volatility and/or a greater decline in value than the corresponding equity of a company.

Different guidance will apply next year.

Once companies figure out how to navigate through the impairment model this year, one of next year's challenges (regardless of whether the markets remain volatile) will be to apply the provisions of new accounting standards related to fair value and business combinations, which take effect in 2009. These standards provide additional prescriptive guidance on how to determine fair value, as well as increase the amount and types of assets and liabilities that companies must consider when measuring goodwill impairment.

Next steps

Today's economic uncertainties, coupled with the complexities of goodwill impairment testing, will require companies to critically assess the assumptions used in their analyses. There may be more close calls than in years past, as well as challenges in undertaking the difficult task of performing all the valuations required within a compressed time frame. Accordingly, companies should begin their testing process early and consider seeking outside accounting and valuation assistance. In short, don't go it alone.

Companies should gather as much information as possible to support their analyses. Documentation and disclosure of key judgments and assumptions—with a particular emphasis on how they reflect current economic conditions and represent market participant assumptions—will be important, especially given the current turbulence in the capital markets. Even for companies that do not recognize an impairment, management should consider early warning disclosures and their plans to further evaluate the business for impairment in future periods.

It may be some time before we understand the long-term implications of the current crisis on valuations. But we know one thing for sure. Goodwill impairment testing will play a leading role once again.

PwC publications and resources

PwC has developed the following publications related to business combinations and noncontrolling interests, covering topics relevant to a broad range of constituents.

- *10 Minutes on Mergers and Acquisitions*—targeted to chief executive officers and board members
- *What You Need to Know about the New Accounting Standards Affecting M&A Deals*—designed for senior executives and dealmakers
- *Business Combinations and Consolidations*…the new accounting standards—an executive brochure on the new accounting standards
- *IFRS 3 (Revised) Impact on Earnings*—The Crucial Q&A for Decision Makers—designed for senior executives and dealmakers
- *A Global Guide to Accounting for Business Combinations and Noncontrolling Interests: Application of US GAAP and IFRS Standard*s—aimed at accounting professionals and dealmakers
- DataLine 2008–01: FAS 141(R), "*Business Combinations*"—written for accounting professionals and dealmakers
- DataLine 2008–02: FAS 160, *"Noncontrolling Interests in Consolidated Financial Statements"*—written for accounting professionals and dealmakers
- DataLine 2008–24: *"Third Quarter Considerations Given Current Market Conditions"*—written for accounting professionals and dealmakers
- DataLine 2008–30: "*Key Considerations for Implementing FAS 141(R) and FAS 160*"—written for accounting professionals and dealmakers

PwC clients who wish to obtain any of these publications should contact their engagement partner. Prospective clients and friends should contact the managing partner of the PwC office nearest you. For more information on this publication please contact:

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