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# ***Qualitative Goodwill Impairment Assessment***

Based on ASU 2011-08:  
Intangibles – Goodwill  
and Other (Topic 350):  
Testing Goodwill for  
Impairment

October 2011



## Purpose and Instructions

*The purpose of this template is to assist preparers by illustrating a methodology to perform a qualitative assessment ("Step 0 analysis") to determine whether it is necessary to perform the two-step goodwill impairment test. Specifically, this template illustrates how to:*

- a. Summarize the totality of events and circumstances considered in a Step 0 analysis*
- b. Consider the extent to which adverse events and circumstances could affect the comparison of a reporting unit's fair value with its carrying amount*
- c. Consider positive and mitigating events and circumstances that may affect the determination of whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount*
- d. Summarize the rationale for the determination of whether it is more likely than not that the fair value of its reporting unit is less than its carrying amount.*

*If the entity has had a recent fair value calculation of a reporting unit and preparers were to use this example template, they would start by populating the "Summary Data" section based on that fair value calculation and document any material changes in carrying amount of the reporting unit. Preparers could then consider the impact of the three categories of events and circumstances listed (i.e., key factors used in the Income and Market Approaches and Additional Key Factors) and their relative impact on the fair value of the reporting unit. The relative weight of the events and circumstances can be documented in the columns provided (i.e., adverse, neutral, positive, other) with supporting rationale for the relevance and weight given to the event or circumstance as an explanation in a footnote. Relative impact (i.e., high, medium, low) should consider both how significant the factor is in determining fair value, as well as relative changes from the prior year that may impact the conclusion.*

*This template contains suggested events and circumstances that are not intended to be all-inclusive, as an entity may identify other relevant events and circumstances, e.g., industry-specific or geographical, to consider in determining whether to perform the first step of the two-step impairment test.*

*After considering the relevant events and circumstances and the extent to which they could affect the comparison of a reporting unit's fair value to its carrying amount, preparers can summarize their analysis and form a conclusion indicating whether it is more likely than not that the reporting unit's fair value is less than its carrying amount.*

*Supplemental appendices should also be attached. It is recommended that the following type of information be provided to support the preparer's analysis that a Step 1 analysis is not required:*

- Market data for the reporting unit (or the parent company), if a public registrant, and the guideline comparable companies (e.g., trends in market capitalizations and multiples)*
- Management's five-year forecast (if available)*
- The reporting unit's current and prior year balance sheet*
- A comparison of the prior-year actual results relative to budgeted performance*
- The results of the most recent fair value (FV) calculation (if relevant), including sensitivity analyses (if possible) that demonstrate the discount rate and market multiples required to arrive at a FV that falls below the reporting unit's carrying amount (CA).*
- Support for all macro-economic and market-based indicators considered in Management's analysis*
- Relevant industry overviews, etc.*

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## ***Background and Executive Summary***

ABC Company ("ABC RU" or "the Company") was founded in 1996 and is a reporting unit of XYZ Corporation ("XYZ Corp"). ABC RU operates primarily in the United States and specializes in the manufacturing and distribution of widgets. The Company's customer base is comprised primarily of local, regional and national retailers. The end users of its products are individual consumers and households that use different variations of widgets and related products.

XYZ Corp acquired ABC RU in 2002 in exchange for \$65 million cash consideration. XYZ Corp. recorded approximately \$20 million of goodwill in connection with this transaction, and through two other bolt-on acquisitions, an additional \$15 million, thereby increasing ABC RU's total goodwill balance to \$35 million. Management performed a fair value (FV) measurement of ABC RU when performing its prior year goodwill impairment analysis on October 1, 2010. As of that date, ABC RU's FV exceeded its carrying amount (CA) by 25%. Through a series of sensitivity analyses performed, Management determined that an 18% weighted average cost of capital ("WACC") and a -0.5% long-term growth rate were required in order for the estimated FV of ABC RU derived using an income approach to fall below its CA, both of which Management believes to be unlikely given today's current economic environment. Similarly, a decrease from 8.0x to 4.0x in the enterprise value to EBITDA multiple was required for the estimated FV of ABC RU derived using a market approach to fall below its CA. This multiple is significantly lower than the observed multiples for XYZ Corp and ABC RU's guideline peers, including Widget Corporation ("Widget Co."). No relevant sector-specific guideline transactions occurred since the date of the most recent impairment analysis that should be used to indicate ABC RU's FV.

Through a series of restructurings and operational improvements, as well as a growth in demand for the Company's products, ABC RU's revenues have grown steadily from \$55 million in 2002 to \$120 million since 2002 and its operating margins expanded 10%. Gross margins increased 1% over the prior twelve months, and ABC RU outperformed budgeted operating profitability, as measured by earnings before interest, taxes, depreciation, and amortization ("EBITDA"), by 3% during the most recent fiscal year.

Overall, the market in which ABC RU operates, the manufacturing sector, has grown increasingly competitive since the most recent impairment testing date. Demand for newer versions of ABC RU's Widget line has increased steadily, although the Company lost market share to other competitors that manufacture imitator products at a lower price point during the previous 12 months.

General macro-economic trends have been disappointing as growth of the United States economy, as measured by real gross domestic product, has trended significantly lower than the historical average of 3% per annum, and even lower than the 2.3% rate observed from 2005 through 2007. Conversely, ABC RU has experienced increased access to capital at lower rates, and the manufacturing sector appears to be expanding based on changes in the Purchasing Managers Index ("PMI") since the prior impairment testing date, October 1, 2010. Management believes both factors mitigate the general US macro-economic climate.

Lastly, XYZ Corp's market capitalization has trended higher during the previous twelve months, as has the market capitalization and implied market multiples of ABC RU's guideline peers, including Widget Co., which Management has identified as a direct competitor of ABC RU.

When considering all factors in totality, Management believes it is more likely than not that the FV of ABC RU exceeds its CA. As such, no further analysis is required for purposes of testing ABC RU's goodwill for impairment.

**Reporting unit (RU):** ABC Company (ABC RU)

**Industry:** Manufacturing (Widgets)

**Date of current analysis:** October 1, 2011

### Summary Data

Reporting unit's current carrying amount (CA) of equity	\$102 million
Date of most recent baseline valuation (prior Step 1 analysis)	October 1, 2010
Fair value (FV) of equity (as of prior Step 1 analysis)	\$125 million
Carrying amount of equity (as of prior Step 1 analysis)	\$100 million
Margin of passing most recent Step 1 analysis	25%
TEV <sup>a</sup> / EBITDA Multiple required to fail prior Step 1 analysis	Market Approach (Selected EV/EBITDA multiple): 4.0x (8.0x used in prior analysis)
Discount rate required to fail prior Step 1 analysis	18% (13% used in prior analysis)
Long-term growth rate required to fail prior Step 1 analysis	-0.5% (3% used in prior analysis)

### Explanation of material changes in CA between valuation dates

*There have been no material changes in the CA since the prior impairment testing date. Increases in ABC RU's CA relate primarily to an increase in the cash balance allocated to the reporting unit and changes in working capital accounts.*

<sup>a</sup> TEV refers to Total Enterprise Value

**Category 1: Key Events and Circumstances Affecting Fair Value Using the Income Approach**

This category focuses on events and circumstances that impact inputs that affect the reporting unit's fair value.

Factor	Adverse	Neutral	Positive	Other	Relative Impact
Changes in industry/ competitive environment	X				Low (1)
Changes in reporting unit's cost factors (materials, labor, etc.)		X			Low (2)
Changes in business strategy or product mix					N/A
Changes in buyer/supplier bargaining power					N/A
Changes in reporting unit's total industry market share	X				Low (1)
Change in potential market (market size)			X		Medium (1)
Changes in planned capital expenditures	X				Medium (2)
Consistency of operating margins/cash flows			X		High (2,3)
Change in reporting unit / product life cycle stage (i.e. growth, mature, decline)					N/A
Earnings quality/sustainability			X		Medium (4)
Budgeted-to-actual performance for prior year			X		High (5)
US gross domestic product (GDP)	X				Medium (6)
Current interest rate environment		X			Medium (7)
Natural gas pricing (key input)			X		Medium (8)
Purchasing Managers Index (PMI)		X			Medium (9)

**Significance of events and circumstances identified and their relative impact on overall analysis:**

- (1) ABC RU's market share declined 1% since the most recent impairment testing date; however, the overall market for ABC's products increased 10%, which partially offsets this decline in market share.
- (2) Gross margins expanded 1% since the most recent impairment testing date due to improved cost controls over raw materials; however, capital expenditures increased 10% beyond what was forecast in ABC RU's most recent projections, thereby reducing net cash flow. Notwithstanding this increase in capital expenditures required to achieve forecasted growth, operating margins (as measured by EBITDA) are up slightly (3%) relative to expectations.
- (3) ABC RU's revenue grew 5% since the most recent impairment testing date.
- (4) No part of ABC RU's net income was comprised of significant non-operating or non-recurring gains or losses, and no significant changes in balance sheet accruals were noted.
- (5) When comparing forecast prior year EBITDA to actual EBITDA, ABC RU outperformed its budgeted performance by approximately 3%. As such, ABC RU is performing slightly better than Management forecast at the date of the most recent impairment test.
- (6) The US economy has increased at an annual rate of approximately 1.3% as of Q2 2011, as measured by real gross domestic product, since the most recent impairment testing date. Overall, the economy is experiencing growth at a lower-than-expected rate as well as a lower rate when compared with prior, pre-recession years (averaging 2.5% from 2005-07).
- (7) The 20-year US treasury rate yields have decreased from 3.4% to 2.51% since the prior impairment testing date. This change does not meaningfully impact the analysis.
- (8) US natural gas pricing has decreased by approximately 6% since the prior impairment testing date. This has had a positive impact on operating margins.
- (9) The PMI index, which provides an indication of the overall health of the manufacturing sector, increased 4% to 52 since the most recent impairment testing date. A PMI of over 50 represents an expansion in the manufacturing sector.

**Although ABC RU faced increased competitive pressure during the last twelve months, any loss in market share was partially offset by the increase in the overall market for its products. While the overall US economy is performing below its historical norm (1.3% real GDP vs. 2.5% from 2005 - 07), economic indicators suggest the manufacturing sector is expanding. Capital expenditures exceeded amounts forecast in the prior year budget as Management was forced to expand manufacturing capacity as a result of a significant unexpected opportunity to service a new customer, which Management views to be a positive factor when viewed in the intermediate / long-term. ABC RU is performing in-line with expectations and experienced no other significant events.**

**Category 2: Key Events and Circumstances Affecting Fair Value Using the Market Approach****This category focuses on events and circumstances that impact inputs that affect the reporting unit's fair value.**

<b>Factor</b>	<b>Adverse</b>	<b>Neutral</b>	<b>Positive</b>	<b>Other</b>	<b>Relative Impact</b>
Trend in XYZ Co's market capitalization			X		High (10)
Trend in peer company market capitalizations			X		Medium (11)
Changes in industry-relevant metrics (YoY <sup>b</sup> and relative to peers)		X			Medium (10, 11)
Trend in XYZ Co's TEV / EBITDA multiple (YoY and relative to peers)			X		High (10, 11,12)
Trend in peer TEV/EBITDA multiples (since most recent impairment testing date)		X			High (11, 12)
Implied multiples from relevant guideline transactions since the most recent impairment testing date					N/A
Profitability ratios YOY and relative to peers			X		Medium (13)

**Significance of events and circumstances identified and their relative impact on overall analysis:**

- (10) XYZ Co, whose stock trades on the NASDAQ exchange, increased 12% since the prior impairment analysis was performed. Management believes ABC RU's equity value is highly correlated with XYZ's stock price as ABC RU comprises approximately 25% and 31% of XYZ Co's consolidated revenue and EBITDA, respectively.
- (11) The stock prices of ABC RU's guideline peers increased 15% on average since the most recent impairment testing date.
- (12) ABC RU's TEV/EBITDA multiple must decrease 4.0x before the CA of the reporting unit exceeds its FV based on the most recent impairment testing date using trailing twelve months EBITDA. On average, TEV/EBITDA multiples for ABC RU's guideline peer group increased 2.0x since the most recent impairment testing date. The TEV / EBITDA multiple for one guideline public peer, Widget Co., which is a direct competitor of ABC RU, increased 2.5x since the most recent impairment testing date.
- (13) ABC RU's gross margins expanded 1% and EBITDA increased 3% during the previous twelve months. This is in-line with changes in margins observed for a majority of the guideline public peers that are exposed to similar business risks.

**Management believes the increase in XYZ Co's market capitalization, the guideline public peer TEV / EBITDA multiples (including Widget Co, which Management believes to be directly comparable to ABC RU) and increases in ABC RU's gross and operating margins are key positive data points in the analysis.**

<sup>b</sup> YOY refers to "year-over-year"

**Category 3: Additional Factors**

**This category focuses on various other factors with potential to impact the fair value of the reporting unit and their impact on the goodwill impairment analysis.**

<b>Metric</b>	<b>Adverse</b>	<b>Neutral</b>	<b>Positive</b>	<b>Other</b>	<b>Relative Impact</b>
Key management turnover	X				Medium (14)
Credit environment / access to capital			X		Low (15)
Pending litigation / potential settlements					N/A
Fluctuations in foreign exchange rates					N/A
Changes in regulatory / political environment					N/A
Overall change in economic environment (macro / micro)	X				Medium (16)
Likelihood of selling / disposing all / a portion of the reporting unit					N/A

**Significance of factors identified and their relative impact on overall analysis:**

- (14) The head of ABC RU's innovation and strategy group resigned to join a competitor as CEO; however, he was replaced by a qualified external hire. Management believes there is little risk this will disrupt ABC RU's culture or product development pipeline and expects business as usual.
- (15) As described above, the US economy grew at a lower-than-expected rate during the most recent twelve months based on the observed 1.3% growth in real gross domestic product as compared to pre-recession average growth of 2.5% between 2005 and 2007. Banks have been increasingly willing to lend to ABC RU and interest rates on ABC RU's revolving credit facility, which is collateralized by ABC RU's fixed assets and receivables, have decreased by 35 basis points. Overall, the manufacturing sector appears to be expanding based on economic indicators (i.e., the PMI which exceeded 50 since the most recent impairment testing date).
- (16) The US economy is trending at a lower growth rate than expected. The sector within which ABC RU operates has become slightly more competitive, although demand for ABC RU's products has continued to grow. No substitute products exist that could potentially disrupt ABC RU's sales in a meaningful way.

**Management believes the bench strength of ABC RU's existing management team and its ability to quickly replace the head of innovation and strategy with a qualified external hire mitigate the impact of the loss of this key employee. Furthermore, Management notes increased access to capital at lower interest rates, and although the general economic environment is trending lower-than-expected, the manufacturing sector appears to be expanding. No significant changes have occurred in the industry that creates significant concern for ABC RU.**

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## *Summary and conclusion*

Management notes that the FV of ABC RU exceeded its CA by 25% when it performed its most recent Step 1 analysis in the prior year. In order to fail that analysis, an 18% discount rate would have been required, which represents a 500 basis point increase over the calculated ABC RU WACC from prior year, which Management believes is unlikely. Furthermore, a 4.0x decrease (from 8.0x to 4.0x) in the selected TEV / EBITA multiple used to estimate the FV of ABC RU when the most recent FV calculation was made would have been required to fail Step 1. As discussed above, the implied TEV / EBITDA multiple for XYZ Co increased along with ABC RU's guideline public peers, including Widget Co., which Management believes to be most comparable to ABC RU. Each of these factors suggests that it is more likely than not that the FV of ABC RU would exceed its CA.

From an operating perspective, ABC RU exceeded budgeted EBITDA by 3% during the most recent 12 month period. ABC RU's revenues grew by 5% and its gross margins expanded by 1%. Although capital expenditures exceeded budgeted amounts by 10%, Management attributes this to an unanticipated opportunity with a new customer that will further increase the value of ABC RU in the near term (i.e., it represents capital spent to achieve growth that was not previously reflected in Management's projections).

The market in which ABC RU operates expanded slightly during the prior twelve months as measured by total unit sales. ABC RU gave up market share to its competitors during that time period as its main competitor, Widget Co., manufactured an imitator product, which they offered at a price lower than ABC RU's product. While Widget Co. was able to increase its market share, it reported operating margins that were 3% lower than its previous fiscal year, primarily due to losses on this new imitator product. Management notes that Widget Co. has since increased its pricing so that they are now priced competitively with ABC RU's product. Over the past year, the overall demand for the products ABC RU manufactures has increased and essentially offsets the impact from Widget Co.'s increase in market share. Management believes that the increased competition in the previous fiscal year was a short term event and will not affect ABC RU's operations in the future.

The market in which ABC RU operates expanded slightly during the prior twelve months as measured by total unit sales. ABC RU gave up market share to its competitors during the most recent 12 month period, but the overall demand for products ABC RU manufactures increased and essentially offset this decline.

Although the economy is growing at rate that is lower-than-expected (i.e., 1.3% real GDP versus the historical average of 3%), Management notes an expansion in ABC RU's sector, the manufacturing sector, as measured by the PMI, which increased 4% from the prior year and exceeded 50. Generally, a PMI index level above 50 indicates an expansion of the manufacturing sector, which Management believes to be a positive factor for ABC RU.

Lastly, turnover at a key senior management position occurred but was immediately filled with a qualified replacement, with no impact expected on the business or product development pipeline.

When considering the relevant events and circumstances above, Management does not believe it is more likely than not that the CA of ABC RU exceeds its FV. As such, a Step 1 analysis is not required at this time.

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