

Alert

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Is Step 1 of Goodwill Impairment Test an Equity, Enterprise or Total Asset Test?

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VRC NEWS

VRC will be holding a webcast, *Current Issues in Accounting for Business Combinations*, on March 23.

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Over the past several months there has been significant debate, when performing a step 1 goodwill impairment test, as to the appropriate test level. The alternatives are: (i) enterprise (or invested capital) level, (ii) total asset level, or (iii) equity level. In this *Alert*, we offer our perspective on which level is preferable and address the differences in conclusions depending on which level is used to perform the step 1 goodwill impairment test.

ASC 350 states that the first step of the goodwill impairment test compares the fair value of a reporting unit with its carrying amount, including goodwill. The fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date. ASC 350 is silent as to the definition of the “unit as a whole” and as such the level at which goodwill is tested for impairment, in a step 1 calculation, is left to interpretation. Enterprise, total assets and equity are the most commonly used levels for step 1 impairment testing. Each level is defined below with a list of advantages (+) and disadvantages (-):

Enterprise Level – The enterprise level test is completed by comparing the carrying value of the enterprise with its fair value. The enterprise value (EV) is commonly defined as debt plus equity or total assets less debt-free current liabilities adjusted for deferred taxes. The enterprise level test offers the following advantages and disadvantages:

- + Generally accepted valuation methodologies and techniques are designed to determine EV;
- + The EV reflects the fair value of debt and equity; thus, avoiding the issue of trying to determine the fair value of debt or the timing of debt repayment;
- + Many transactions are consummated at EV level; thereby providing important valuation inputs and market based support for value conclusions;
- + If a step 2 calculation is required to measure the fair value of goodwill, EV provides a logical starting point.

Total Asset Level – The total asset level test is completed by comparing the carrying value of total assets with its fair value. The total asset level test offers the following advantages and disadvantages:

- + Testing level would appear to be logical since in step 1, we are determining if goodwill impairment may exist;
- The fair value of total assets cannot be directly calculated, as such EV must first be calculated and then adjusted for debt-free liabilities and deferred taxes.

Equity Level – The equity level test is completed by comparing the carrying value of the equity with its fair value. The equity level test offers the following advantages and disadvantages:

- + The carrying value can be directly taken from the reporting unit’s balance sheet;
- + If the reporting unit is a public company with a single reporting unit, a simple comparison of market capitalization with the carrying value of equity can provide an initial step 1 indication;

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- Valuing the equity requires accounting for the debt of the reporting unit. Significant diversity exists regarding whether debt should reflect fair value, book value or the current obligation. The method of incorporating debt may lead to different step 1 conclusions;
- In situations where the reporting unit has negative equity, the step 1 conclusion would result in no impairment, since the fair value of the equity cannot be below zero. This conclusion is not intuitive and differs from the conclusion at the total asset or enterprise value level.

CASE STUDY

VRC recently worked with a company that was distressed and had significant operating losses. Given the current economic environment, the company was not expecting a significant improvement in operating income. In our view, the company's goodwill was likely impaired given its poor historical performance, expected future performance and the magnitude of goodwill on its books. In performing the step 1 analysis at the enterprise level, VRC found that the fair value of the company was less than its carrying value, thus indicating that goodwill may be impaired. A total asset level test delivered the same conclusion. The equity level step 1 test was less definitive. If the fair value of the equity was calculated utilizing the fair value of debt (based on current market pricing), impairment was not indicated as the fair value was greater than the carrying value. On the other hand, if the value of the equity was based on the face value of the debt or the remaining obligation, the fair value of equity would be less than the carrying value of the equity indicating impairment. The use of debt at its book value, fair value or estimate of obligation in determining the fair value of the equity is an area of disagreement among valuation professionals.

CONCLUSION

Although there are advantages and disadvantages for each of the testing levels, for most businesses, the enterprise level test is believed to be the most appropriate method for determining whether goodwill impairment may be indicated. It is neutral with respect to the reporting unit's capital structure and is an entity level test for an entity level asset. VRC has assisted many companies with impairment testing. For questions pertaining to impairment testing, contact your VRC representative.



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