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FINANCIAL REPORTING UPDATE

Goodwill Impairment

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Financial Reporting Fallacy

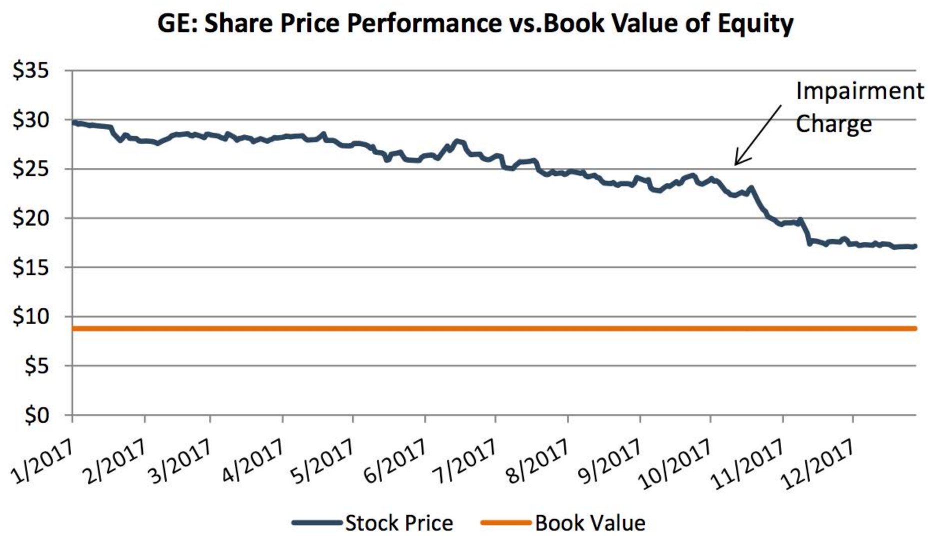
The Whole May Appear Healthier Than the Parts

A logical fallacy occurs when one makes an error in reasoning. Causal fallacies occur when a conclusion about a cause is reached without enough evidence to do so. The cum hoc ("with this") fallacy is committed when a causal relationship is assumed because two events occur together.

When it comes to financial reporting, an example of this fallacy would be assuming that goodwill cannot be impaired unless the company's shares are trading below book value. This is a tempting fallacy–especially as the U.S. economy is continuing a long expansion, companies are posting solid earnings, and valuations are reaching new highs. The S&P 500 increased 19% in 2017 and the Nasdaq was up 28%. In these market conditions, goodwill impairment probably does not seem like a pressing concern. After all, goodwill is considered impaired only when fair value drops below carrying value, right? While this is true, accounting standards require that goodwill be tested for impairment at the reporting unit level. Impairment relates to a reporting unit's ability to generate cash flows. This means that a company's goodwill can be impaired at the reporting unit level, even as its stock trades above book value.

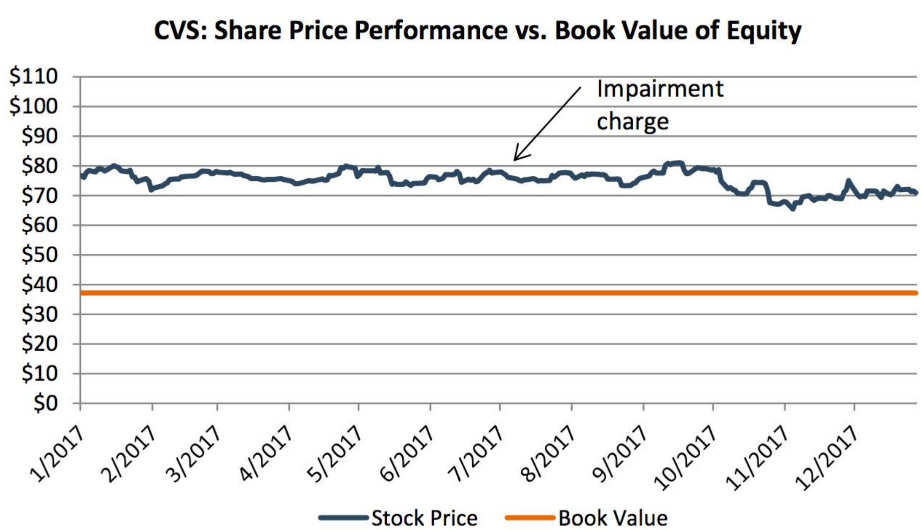
> A company's goodwill can be impaired at the reporting unit level, even as its stock trades above book value

This was the case for multinational conglomerate General Electric last year. GE had a tumultuous 2017 as the company's CEO and CFO departed, the dividend was cut, and a corporate restructuring was announced. The salient event for the purposes of this article is a $947 million impairment loss recorded in its Power Conversion Unit during the third quarter of 2017. This unit is what became of GE's 2011 $3.2 billion acquisition of Converteam, an electrical engineering company. According to the company's 2017 annual report, the causes for this impairment included downturns in marine and oil and gas markets, pricing and cost pressures, and increased competition. GE's stock felt the turmoil, falling 42% in 2017. Shares traded at $17.25 at their lowest point, implying a market capitalization of $150.5 billion. But even at this point, GE's stock was not trading below book value ($64.3 billion at the end of 2017). GE's market value exceeded book value of equity by $86.2 billion. So while impairment and market value/share price are related, it is not safe to assume that there is no impairment if the stock trades above book value.



Share prices per Yahoo! Finance; Book Value represents highest value for the year per SEC filings

Another notable example is CVS Health. The company made headlines with one of the largest mergers of the year when it announced the acquisition of insurer Aetna, Inc. for $69 billion in December 2017. A smaller, less widely reported transaction transpired in November when the company announced the sale of its RxCrossroads reporting unit to McKesson Corp. for $735 million. This unit was part of CVS's 2015 acquisition of nursing home pharmacy Omnicare, Inc. and provided reimbursement assistance and sales operation support, among other services. In the second quarter of 2017, CVS recognized a $135 million impairment charge related to this reporting unit. As with GE, CVS never traded below book value. CVS stock declined approximately 8% in 2017 and hit a low of $66.45 on November 6. The market capitalization at this point was approximately $67.7 billion. The book value of CVS equity was $34.9 billion at September 30, 2017 and $37.7 billion at year-end.



Share prices per Yahoo! Finance; Book Value represents highest value for the year per SEC filings

The above examples expose the fallacious idea that a company can avoid impairment charges simply because its stock trades above book value. That is not to say that there is no relationship between the two; an impairment charge can certainly signal the market and affect share price, or a decline in share price may foreshadow an impending impairment charge. Because goodwill must be tested for impairment at the reporting unit level, impairment may occur even when the company's market cap exceeds book value.

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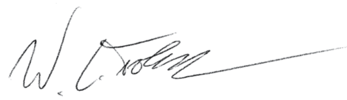

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Industry Considerations for Step Zero

Qualitative Assessments

What is Step Zero?

A qualitative approach to test goodwill for impairment was introduced by the Financial Accounting Standards Board ("FASB") when it released Accounting Standards Update 2011-08 ("ASU 2011-08") in September 2011 as an update to goodwill impairment testing standards under *Topic 350, Intangibles—Goodwill and Other*. ASU 2011-08 set forth guidance for an optional qualitative assessment to be performed before the traditional quantitative two step goodwill impairment testing process. This preliminary qualitative assessment is known as "Step Zero." The goal of Step Zero is to simplify and reduce costs of performing the traditional quantitative goodwill impairment test process.

According to ASU 2011-08, Step Zero allows entities "the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount."

Step One is required only if the qualitative assessment supports the conclusion that it is more likely than not (i.e., likelihood greater than 50%) that the fair value is less than the carrying value. Otherwise, Step One of the goodwill impairment testing process is not required. Alternatively, Step Zero can be skipped altogether, and the traditional quantitative goodwill impairment test can be performed beginning with Step One.

Industry Considerations

The standards update release by FASB outlines the individual qualitative categories of the assessment. Specific qualitative events and circumstances to be evaluated include the economy, industry, cost factors, financial performance, firm-specific events, reporting unit events, and changes in share price.

ASU 2011-08 defines industry events and circumstances as follows:

> "Industry and market conditions such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development."

The process of evaluating an industry involves assessing each of these stated events and circumstances since the previous reporting period and determining how they affect the comparison of fair value to carrying value. By comparing current conditions to the prior period, an analysis of relative improvement or deterioration can be made concerning each industry factor and the industry as a whole.

Increasing multiples, share prices, financial metrics, and M&A activity indicate that an industry is improving and suggests that it is more likely than not that the reporting unit's fair value is greater than its carrying value. Decreasing multiples, share prices, financial metrics, and M&A activity indicate the industry is weakening and suggests that fair value may be less than the reporting unit's carrying value.

Industry Analysis

An analysis of the S&P 1500, an index that includes approximately 90% of the market capitalization of U.S. stocks, reveals the prevalence of impairment in different industries. For example, of the companies reporting goodwill on their balance sheets, 25% of telecommunication, 17% of consumer staples, and 14% of consumer discretionary companies recorded goodwill impairment charges in 2017.

S&P 1500 Goodwill Impairment Industry Analysis

Industry:	Total Companies	(A) Companies Reporting Goodwill	(B) Reported Impairment in 2017	(B) / (A) Impairment as % of Reporting Goodwill	(C) Impairment Candidates (Cushion < 25%)	(C) / (A) Candidates as % of Reporting Goodwill
Consumer Discretionary	241	176	24	14%	8	5%
Consumer Staples	67	58	10	17%	2	3%
Energy	91	44	4	9%	9	20%
Financials	226	161	6	4%	11	7%
Healthcare	168	145	18	12%	4	3%
Industrials	227	197	20	10%	1	1%
Information Technology	223	200	8	4%	3	2%
Materials	87	73	8	11%	3	4%
Real Estate	106	25	1	4%	0	0%
Telecommunication Services	12	8	2	25%	3	38%
Utilities	52	40	4	10%	0	0%
Total	1500	1127	105	9%	44	4%

Source: S&P Capital IQ

On the other hand, the more robust performance of financial, information technology, and real estate companies is manifest in that only 4% of companies reporting goodwill in each industry recorded a goodwill impairment charge in 2017.

Further analysis indicates that companies in the energy and telecommunication industries are currently more likely to be potential impairment candidates as 20% and 38%, respectively, of companies reporting goodwill have cushions (the amount by which market value of equity exceeds book value of equity) of less than 25%. Deterioration in the operating environment of these industries may result in an increase in goodwill impairment charges. Industries with fewer impairment candidates at the moment include real estate, utilities, and industrials.

Industry considerations are particularly important to the qualitative assessment and provide valuable insight on the potential for impairment. The qualitative assessment is especially valuable in industries that are performing well as it is less likely that goodwill is impaired.

Industry considerations are particularly important to the qualitative assessment and provide valuable insight on the potential for impairment

Step Zero provides the opportunity to perform a preliminary qualitative analysis to determine the necessity of performing the traditional two step goodwill impairment test and can lead to a simpler, more efficient impairment testing process.

The analysts at Mercer Capital have experience in, and follow, a diverse set of industries. We help clients assemble, evaluate, and document relevant evidence for the Step Zero impairment test. Call us today so we can help you.

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Accounting Standards Update 2016-01

Impairment Considerations for Equity Investments

ASU 2016-01 shook up financial reporting at the beginning of the year, as companies scrambled to determine compliance with the new requirements for reporting equity investments.

The rise of corporate venture capital over recent years largely flew under the accounting radar until this update took effect, creating significant volatility for many corporate investors in their reported earnings as they were required to recognize the gains and losses from investments previously held at cost.

Now that the initial shock has worn off, CFOs may be able to rest a little easier, but they shouldn't forget about the requirements under ASU 2016-01 entirely.

Even if the company elected the measurement alternative that allows for the investment to be reported at cost, don't forget about the requirement for impairment testing that goes along with it. Some companies may choose to perform the initial Step Zero analysis internally before engaging a valuation firm to navigate the rest of the process, while others turn over the entire process to a valuation professional.

> *"An entity may elect to measure an equity security without a readily determinable fair value [and that does not qualify for the practical expedient]…at its* ***cost minus impairment, if any****, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer."*
>
> ASU 2016-01 Paragraph 321-10-35-2

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What is the Order of Testing for Impairment?

When testing the goodwill of a reporting unit for impairment, the order of operations matters. Because the units themselves may contain assets subject to impairment testing, it is important to first reflect accurate carrying values for those assets before testing the goodwill of the unit overall.

If the goodwill of the unit is tested before a write down of certain of its assets occurs, there may be increased risk of inaccurately allocating impairment between the assets and goodwill of the unit. Similarly, failing to address the order of testing could lead to the false conclusion that the goodwill of a reporting unit is impaired, when there is really only impairment of its underlying identifiable assets. These errors occur when the unit's fair value of goodwill is compared to an inaccurately high carrying value that results from failing to adjust asset values first.

According to the AICPA Accounting & Valuation Guide: *Testing Goodwill for Impairment* [paragraph 2.57], the order of impairment testing should be as follows:

Order for Impairment Testing	Examples
Adjust the carrying values of non-fixed assets and liabilities	Inventory Accounts Payable
Test indefinite-lived intangibles for impairment and adjust as necessary	Tradename Franchise Agreements
Test amortizable intangibles for impairment and adjust as necessary	Technology Customer Relationships
Test the overall reporting unit goodwill after all adjustments have been made to the carrying values of its underlying assets	Measure the FV of the unit and compare to adjusted carrying value

Financial statement preparers should not neglect the proper order of impairment testing to ensure current allocation of impairment.

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Tax Reform and Impairment Testing

Earlier this year, we considered the impact of the Tax Cuts and Jobs Act of 2017 ("TCJA") on purchase price allocations. In this article, we turn our focus to the impact of the TCJA on goodwill impairment testing. Changes to the tax code will affect both the qualitative assessment (often referred to as Step Zero) and quantitative impairment test.

Qualitative Assessment

Companies preparing a qualitative assessment are required to assess "relevant events and circumstances" to evaluate whether it is more likely than not that goodwill is impaired. ASC 350 includes a list of eight such potential events and circumstances.

Qualitative Assessment Factors	Likely Impact of Tax Bill
Macroeconomic conditions (including developments in equity and credit markets)	Equity markets responded favorably to passage of the tax bill, with the S&P 500 advancing approximately 7% in subsequent months
Industry and market considerations (including market multiples and regulatory/political developments)	Pre-tax valuation multiples (such as EBITDA) have generally expanded in the wake of the tax bill, as a given dollar of pre-tax earnings is expected to yield a larger amount of after-tax cash flow for investors
Cost factors (raw materials, labor, and other costs)	Experience has been mixed as it remains to be seen to what degree tax savings will be allocated among shareholders, employees, customers, and suppliers
Overall financial performance (cash flows and other comparisons to budget)	The tax bill has been viewed by many as promoting overall economic growth (at least in the short-term). As the economy has remained robust in 2018, reported earnings growth has been strong for many sectors
Other entity-specific events including changes in management, personnel, strategy, customers, and litigation	Specific provisions of the tax bill regarding the deductibility of interest and treatment of certain capital expenditures are likely to affect some companies differently than others
Significant events including asset impairments, major dispositions, etc.	Limited direct link, but generally positive economic trends provide a favorable backdrop for most companies
Sustained decrease in share price (both absolute and relative to peers)	The broader market advance has, to some degree, made relative comparisons more difficult

Quantitative Assessment

The same features which, on balance, have made it more likely that reporting units will garner a favorable qualitative assessment also contribute to the fair value of reporting units under the quantitative assessment.

- **Reduction in income tax rate**. All else equal, a reduction in the applicable federal income tax rate from 35% to 21% increases after-tax cash flows and contributes to higher fair values for reporting units.
- **Bonus depreciation provisions**. The tax bill allows certain capital expenditures to be deducted immediately for purposes of calculating taxable income. While the aggregate amount of depreciation deductions is unaffected, the acceleration of the timing of tax benefits can have a marginally positive effect on the fair value of some reporting units.
- **Interest deduction limitations**. One potentially negative effect of the tax bill on reporting unit fair values is the limitation on the amount of interest expense that is deductible for tax purposes. For some highly-leveraged businesses, the interest deduction limitation can increase the weighted average cost of capital. We expect the interest deduction limitations to adversely affect only a small minority of companies.
- **Increase in after-tax cost of debt**. When calculating the cost of debt as a component of the cost of capital, analysts multiply the pre-tax cost of debt by one minus the corporate tax rate. The new lower tax rate will, therefore, cause the after-tax cost of debt to increase by a small increment. All else equal, an increase to the weighted average cost of capital has a negative impact on the fair value of a reporting unit. On balance, we expect the negative effect from higher costs of capital to be smaller than the positive cash flow effect from lower tax rates.

Conclusion

The Tax Cuts and Jobs Act of 2017 is a material factor to be considered in both qualitative and quantitative assessments of goodwill impairment in 2018. While the provisions are not uniformly favorable to higher valuations, the balance of factors suggests that goodwill impairments will be less likely in the coming impairment cycle. To discuss how the new tax regime affects your company's goodwill impairment more specifically, please give one of our professionals a call.

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Goodwill Impairment

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Based upon our former blog, this book compiles our recent thinking across the gamut of financial reporting topics – from fair value and impairment testing to portfolio valuation and equity compensation.

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