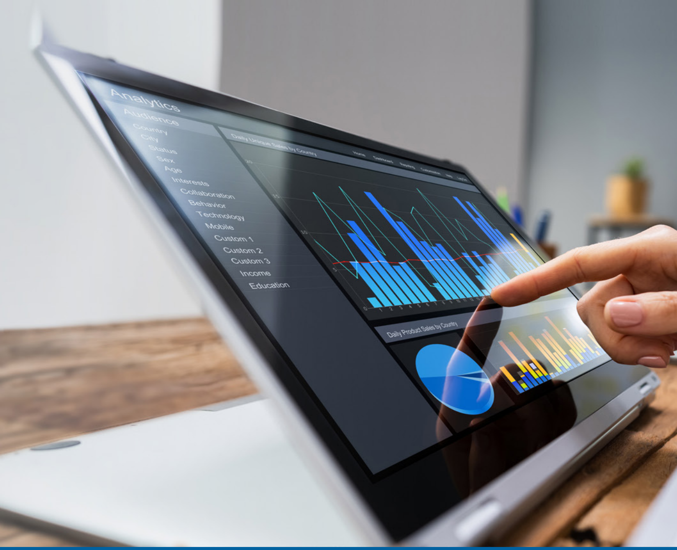
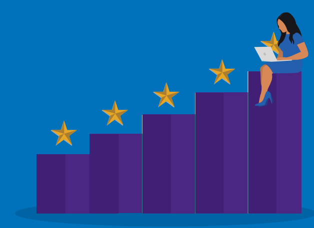
# Goodwill impairment valuation insights



## Avoiding common pitfalls in goodwill impairment valuations

With many companies performing annual goodwill impairment tests in the upcoming months, we wanted to share some of the issues that often arise in these analyses. Below are five of the most common pitfalls to avoid when performing a goodwill impairment test.



### 1. Incorrect ordering of impairment tests

One common area of confusion is the proper ordering of the various impairment tests. When performing a goodwill impairment test, the carrying value of the reporting unit's assets should first be adjusted for any other impairments. The proper sequencing is as follows:

1. Adjust carrying amounts of assets not in scope of ASC 350 or ASC 360.
2. Test and record any impairment of indefinite-lived intangible assets under ASC 350.
3. Test and record any impairment of long-lived assets per ASC 360.
4. Test goodwill for impairment under ASC 350.

### 2. Using a qualitative impairment test for close calls

Step Zero can provide relief for many companies that have a low risk of impairment. However, when applied in the wrong situation, Step Zero could result in more work than would have been otherwise required by a quantitative analysis. Consider the following points before proceeding with a Step Zero analysis:

1. What valuation multiples are required to support a conclusion of no impairment? How does this compare to observed multiples in your industry?
   – For example, if the reporting unit's break-even value implies a TIC[1]/EBITDA multiple of 10.0x and the observed comparable companies are trading between 6.0x and 10.0x, performing a Step Zero qualitative analysis might yield little benefit.
2. What was your cushion in the last quantitative Step One analysis?
   – If the cushion was not substantial, one may find completing a Step Zero analysis to be challenging.
      i. When making this assessment, confirm that your auditor agrees with the amount of cushion you have calculated.
      ii. It is also important to ensure that the cushion is based on a recent valuation. A 30 or 40 percent cushion may prove helpful if a quantitative analysis was performed the previous year, but it is unlikely to carry much weight if the last quantitative test was performed several years ago.
3. If your company is publicly traded, what is your P/B[2] multiple?
   – If your company is trading at a discount to book equity (i.e., P/B is less than 1.0x), performing a Step Zero qualitative analysis may require incremental support such that a quantitative test may take less time and effort.

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[1] Total Invested Capital (TIC) is the sum of debt and equity in a business. This includes common equity, preferred stock, noncontrolling interests, nonequity claims, and debt.

[2] A Price to Book (P/B) multiple is the ratio of the market value of a company's common equity to its book equity value.

## 3. Repeating mistakes from prior years

Regrettably, it is not uncommon that companies make the same mistakes on a recurring basis. For example, items identified during an audit that are not considered material might not receive detailed attention, and changes might not be implemented. As a result, these mistakes can be unknowingly repeated until they become material. To prevent this from happening, it can be helpful to arrange a debrief call with your audit team and their valuation specialists to identify areas where such issues may exist.

## 4. Insufficient documentation

Expectations regarding documentation have increased over time and there does not seem to be an end in sight. Further, the focus areas can change annually in response to evolving best practices or comments received from PCAOB inspections. In addition, the adoption of the CEIV[3] credential should result in more robust documentation being prepared by valuation specialists in order to comply with the credential's requirements. Working with a valuation specialist that focuses on financial reporting matters and is familiar with the CEIV's standards can help minimize the risk of any documentation deficiencies.

## 5. Market capitalization considerations

For public companies, it is important to be aware of how the company's observed market capitalization might impact the goodwill impairment test. For example, if the company's market capitalization is below its book equity value, it is perceived to be at a higher level of impairment risk. Ignoring a prolonged deterioration of a company's market capitalization may lead to an impairment being recognized too late.

Additionally, when reporting units are valued as part of the goodwill impairment process, it is typically expected that the fair values of each reporting unit will be reconciled to the observed market capitalization of the publicly traded parent with a reasonable level of control premium.[4] When the differences are large, it can place a significant amount of scrutiny on the control premium assumption. In addition, ensuring that all pieces of the business, including corporate assets and liabilities, are fully captured in the market capitalization reconciliation is important.

## Summary

While not comprehensive, this document provides five common issues that can arise in a goodwill impairment analysis. Hopefully, by being mindful of these potential pitfalls, the risk of unanticipated challenges and delays arising during the next goodwill impairment test can be reduced.

### Additional resources

For additional insight into goodwill impairments, be sure to check out these additional resources:

— Goodwill Impairment Valuation Insights—A discussion of the market participant acquisition premium

— Goodwill impairment Valuation insights—FAQs

— Handbook: Impairment of nonfinancial assets

[3] For additional information on the Certified in Entity and Intangible Valuations (CEIV) credential, see What is the CEIV and why does it matter for fair value measurements?

[4] Also referred to as a market participant acquisition premium (MPAP).

# Contact us

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