CRA Insights:
Credit Crisis

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The effects of the Credit Crisis of 2008 were significant and widespread—affecting not just the financial sector but the entire economy. The role that new fair value disclosure requirements for financial companies and their assets played continues to be debated. Corporate management and counsel should be aware that goodwill and other non-financial assets and liabilities are also subject to periodic fair value evaluation.

This article discusses the likelihood of significant corporate write-offs of goodwill and other non-financial assets, the consideration of stock prices in determining impairment, and the potential economic effects and litigation risks involved.

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CRA INTERNATIONAL

Goodwill Impairments Are Coming: What to Look For, How to Mitigate Litigation Risk

Non-financial assets and the credit crisis

The credit crisis of 2008 has changed the financial sector's landscape forever. Several financial companies have failed, several have been taken over by stronger competitors, and many of the firms lost 80 percent or more of their market value. But the market price decline was not confined to the financial sector. With the United States economy now officially in recession, the credit crisis has clearly affected the entire economy. The S&P 500 index, which represents a broad cross-section of the economy, declined by about 38.5 percent in 2008, its worst decline since 1937. While the financial sector represented in the S&P 500 index declined the most, most sectors represented in the index fell more than 30 percent.

In what may be a big surprise to corporate general counsel, litigators, and managers, the fair value disclosure effects of 2008's historic stock price declines will not be limited to just financial companies and their financial assets and liabilities.[1] Goodwill and other non-financial assets and liabilities on a company's balance sheet are also subject to periodic fair value evaluation. Given the widespread 2008 price declines and the recession, there may be a rush of announcements in the coming weeks of large write-downs of goodwill, deferred tax assets, plant and equipment, and non-financial assets.[2] If history is any guide, we may also see several lawsuits related to the amount and the timing of these impairment charges as well as the alleged damages based on stock price declines.

For goodwill and other non-financial assets, the purpose of periodic fair value evaluation is to determine whether "impairment" in the value of the asset has occurred, i.e., whether the fair value of the asset is less than the asset's balance sheet "carrying value." If the fair value evaluation suggests that an "other than temporary" impairment of fair value has occurred, then the company must write down the carrying value of the asset on the balance sheet to the estimated fair value and recognize a corresponding impairment charge (loss) in its income statement. Factors considered for tests of impairment vary by the type of asset evaluated. In testing the goodwill asset for impairment, the market capitalization of the firm is often

[1] Fair value is defined as the price at which an asset can be sold or a liability can be settled. For a background on fair value accounting and litigation risk, see the following CRA International publications: "FAS 157 – Fair Value Disclosures and Litigation Risk," October 2008, and "Mark to... Market or Reality?" October 16, 2008. In a forthcoming article, CRA will address the new "fair value option" accounting rule, which allows companies to adopt fair value reporting for selected financial assets and liabilities.

[2] See, for example, Time Warner's announcement on January 7, 2009, that it "anticipates incurring a non-cash impairment charge on certain of its goodwill and identifiable intangible assets in the fourth quarter of 2008... [and] currently expects the charge will total around $25 billion."

considered relevant, and hence the recent stock price declines are likely to lead to an increased focus on goodwill impairment tests.

As a result of the wave of mergers and acquisitions that started in the late 1990s, goodwill is now a large percentage of the total assets of many corporations; and so, goodwill write-offs, if they occur, can be significant. For example, Proctor & Gamble's balance sheet as of June 30, 2008, has goodwill valued at $59.8 billion, including $38.0 billion resulting from the acquisition of Gillette in 2005. P&G's reported goodwill is about 42 percent of its total assets and about 85 percent of its shareholder equity. In general, technology, media, and consumer products companies tend to have large goodwill accounts due to industry consolidations and acquisition activities. For some technology companies, such as Cisco Inc., goodwill is the largest non-current asset on the balance sheet.

A recent goodwill impairment announcement by CBS Corp. provides an illustration of the magnitude of the forthcoming goodwill and asset impairment charges, as well as the potential litigation risks, for non-financial assets of companies. CBS started 2008 with a goodwill account balance of $18.5 billion. During the year, the company's stock price declined considerably, falling almost 50 percent by September 30, 2008. On October 10, 2008, the company announced that "as a result of adverse market conditions," it conducted an impairment analysis of goodwill and intangible assets that resulted in a goodwill write-off of about $9.6 billion and an additional write-off of about $4.6 billion in other intangible assets. In December 2008, a purported class action lawsuit was filed against the company alleging, among others, the "failure to timely write-down impaired intangible and goodwill assets."

Goodwill accounting basics

Goodwill write-offs can be triggered by a decline in stock market values although a falling stock price is neither necessary nor sufficient for the recognition of goodwill impairment. To understand why stock price declines could precipitate goodwill impairment for some firms, it is useful to review the accounting basics for goodwill recognition and write-off. The goodwill account on the balance sheet is created when a firm acquires another firm or its assets and liabilities for a price that is in excess of the estimated fair values of the individual assets and liabilities acquired. Under the purchase accounting methodology required for business combinations by US accounting standard FAS 142[3], fair values are first determined for all identifiable assets and liabilities acquired, including acquired intangible assets such as brands, royalties, and copyrights. Goodwill is then the excess of the price paid over the fair values of all identifiable assets less liabilities acquired.[4]

Goodwill is thus calculated as a residual, essentially representing unidentifiable intangible benefits from acquisition. For example, FAS 142 suggests that goodwill may be due to, among others, the "control premium" over fair values that a buyer would pay to get acquisition-related synergies. FAS 142 states: "Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity... An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit."[5]

FAS 142 requires that goodwill, once created, should be carried indefinitely at its original value without amortization unless an impairment analysis of the fair value of the reporting unit level indicates that goodwill has been impaired. FAS 142 also requires that goodwill be tested for impairment at least annually and also in the interim between annual tests "if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount."

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[3] Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets," June 2001, as amended, Financial Accounting Standards Board. The corresponding international financial reporting standard, IAS 36, is similar to FAS 142. See International Accounting Standard 36, "Impairment of Assets," as amended, International Accounting Standards Board.

[4] FAS 142 requires that the goodwill be accounted for at the so-called reporting unit level rather than the corporate level (unless the company has just one reporting unit).

[5] FAS 142, para. 23, as amended by FAS 157, para. E22 d.

Impairment and consideration of stock prices

FAS 142 lists several examples of events or changed circumstances that might require an interim test for goodwill impairment. Although none of these examples specifically refers to a decline in the stock market value of the company as a trigger for goodwill impairment analysis, major accounting firms have stated that a significant stock price decline may be a potential event or changed circumstance requiring an impairment analysis for goodwill. For example, an Ernst & Young publication dated October 2008 states: "A significant decline in a company's stock price may suggest that the fair value of one or more reporting units has fallen below their carrying amounts. Similarly, declines in the stock prices of other companies in a reporting unit's industry may suggest that an interim test for goodwill impairment is required."[6] Similar comments on the potential for goodwill write-offs due to recent stock price declines have been included in recent publications by other major accounting firms.[7]

The Securities and Exchange Commission ("SEC") has also said that it expects more goodwill impairment than usual due to the recent declines in stock prices. Robert Fox, a professional accounting fellow at the SEC, said at a recent accounting conference that the need to test for goodwill impairment required judgment and that "this judgment may be more challenging in the current environment due to recent market declines that indicate that a potential impairment exists."[8] He added that the SEC "would expect more goodwill impairment than in recent years..." in the upcoming financial filings. In the same conference, Steven Jacobs, an Associate Chief Accountant at the SEC, indicated that a "decline in market capitalization below book value," including the "duration and severity of [the] difference,"[9] would be an impairment testing indicator for goodwill, assuming factors such as short-term volatility are ruled out as the causes. More interestingly, Mr. Jacobs noted that even in cases where a current impairment charge of goodwill is not taken, companies may be required to provide "early warning disclosures" of potential future goodwill impairment charges if there is a reasonable possibility of loss. These remarks by SEC staff members suggest that the SEC would be looking for an explanation from corporations on how they considered current stock price declines when analyzing goodwill impairment.

The SEC staff appears to have already made these kinds of inquiries during 2008 in some of its "comment letters" sent to companies requesting clarifications related to their 10-K and 10-Q filings. For example, in a comment letter to Regions Financial Corporation dated July 17, 2008, the SEC staff asked the company to explain "How you determined that your goodwill balance is not impaired. Please specifically address how you took into consideration the fact that you have been trading at a market value that is below your book value."[10] The company, in its reply filed on July 1, 2008, responded that "management could not conclude that [lower market value] was a long-term trend, particularly when our stock price was trading above book value in the fourth quarter of 2007. Further, given the relatively small difference between our stock price and our book value per share, we determined that a potential buyer would offer a control premium for our business franchise that would adequately cover these differences between trading prices and book values."

As Regions Financial explained, a commonly claimed mitigating factor when the market value of a company is below its book value is whether the goodwill on the balance sheet represents (or may be justified by) the control premium that a current buyer would pay for the company. Clearly, there is judgment involved in determining the amount of control premium for a reporting unit. However, Mr. Fox, the SEC speaker at the above-mentioned AICPA national conference, cautioned that companies should be prepared to justify the assumptions of control premiums that current buyers would pay given the significant fall in stock prices last year. Mr. Fox said, "I would also note that the amount of supporting evidence supporting your judgment would likely be expected to increase as any control premium increases."

[6] "Recent Market Events: Accounting and Reporting Considerations," Ernst & Young, October 7, 2008.

[7] See, for example, "Mergers & Acquisitions – A Snapshot," PricewaterhouseCoopers, December 2008.

[8] Remarks by Robert G. Fox III before the 2008 AICPA National Conference on Current SEC and PCAOB Developments, December 8, 2008. Available at the SEC website.

[9] Remarks in presentation slides of Steven Jacobs before the 2008 AICPA National Conference on Current SEC and PCAOB Developments, December 9, 2008. Available at the SEC website as part of the presentation by Chief Accountant Wayne Carnall.

[10] Regions Financial Corp., Form CORRESP, filed July 1, 2008.

Some companies have already started to link their goodwill impairment charges explicitly to stock price declines. For example, GateHouse Media Inc., in a filing with the SEC last year, explained the basis for determining a goodwill impairment of $201.5 million in 2007 Q4 as follows: "The Company determined that it should perform impairment testing of goodwill and indefinite lived intangible assets as of December 31, 2007, due to the declines in its stock price, market capitalization, revenue trends and other economic factors, which were most significant in the fourth quarter of 2007. In the second half of 2007 the Company's stock price declined by approximately 52% and the resulting market capitalization of the Company was below the carrying value of its assets. The analysis of the stock prices of other newspaper industry companies identified similar stock price declines in the period... As a result of the declines in stock price and advertising revenue in the second half of 2007 and especially the fourth quarter, the Company reassessed and lowered its expected future cash flows which resulted in a decline in fair value as of December 31, 2007."[11] It should be noted that GateHouse's explanation included its justification for taking the goodwill impairment charge in the fourth quarter of 2007 rather than when the stock price declined in the second quarter of 2007.

Impairment and Economic Effects

Goodwill and asset impairment charges are generally considered "non-cash" in nature, i.e., they affect earnings but not cash flows from operations. Despite the lack of direct cash flow effect, impairment charges may affect a company's operations and future cash flows in several ways because of the use of the reported earnings in loan covenants, employment agreements, compensation plans, etc. For example, large goodwill impairments would increase the debt-equity ratio and could cause violations of some ratio-based loan covenants. There could also be credit rating changes initiated by ratings agencies that could increase the cost of borrowing. Earn-out contracts and contingency payments related to mergers and acquisitions could be dependent on reported earnings, which could affect the cash flows related to these contracts.

What to Look For: Summary

As non-financial companies report their 2008 results in the coming weeks, we are likely to see significant corporate write-offs of goodwill, deferred tax assets, and other non-current assets. The impact on general counsels, corporate counsel, and litigators may include:

- Shareholder and enforcement actions over the timeliness of the write-offs and disclosures,
- Violation of loan covenants and counterparty trading agreements,
- Credit rating changes and resultant borrowing impacts,
- Disputes relating to the calculation of earn-outs and contingency payments from prior acquisitions,
- Disputes relating to employment agreements and compensation plans, and
- Securities sales by funds as a result of financial ratio declines caused by write-offs.

[11] GateHouse Media, Inc., Form CORRESP, filed May 15, 2008.

Credit Crisis Task Force

The full magnitude and impact of the current economic crisis are not yet known. But undoubtedly, the effects on both financial institutions and global business will be profound and lasting. To provide insight into the complex issues raised by the current crisis, CRA has formed a multi-disciplinary Credit Crisis Task Force. We have the expertise to help you both understand the issues and advise you on how best to address them.

CRA International

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Founded in 1965, CRA has headquarters in Boston and 26 offices across North America, Europe, Asia Pacific, and the Middle East.

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