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Preparing For Goodwill Impairments

Law360, New York (February 05, 2009) -- The financial crisis of 2008 has had a great impact on the stock prices of companies in the financial sector's landscape. Stock prices of companies such as Citigroup Inc. and Bank of America Corp. have declined over 80 percent in the last two years. But the market price decline was not confined to companies in the financial sector.

The S&P 500 index, which represents a broad cross-section of the economy, declined by about 38.5 percent in 2008, its worst performance since 1937. While the financial sector represented in the S&P 500 index declined the most, eight out of the 10 sectors represented in the index fell more than 30 percent.

These widespread stock price declines will affect corporate decisions on goodwill and asset impairment. 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, one should expect to see a rush of announcements in the coming weeks of large write-downs of goodwill, deferred tax assets, plant and equipment, and non-financial assets. In fact, the rush may be already on.

Several large financial and non-financial companies have pre-announced large goodwill and other write-offs for the fourth quarter of 2008, including Time Warner Inc. ($25 billion), ConocoPhillips ($39 billion) and Royal Bank of Scotland ($22 to $29 billion).

If history is any guide, we may also see several lawsuits following the asset impairment announcements related to the amount and the timing of these impairment charges as well as the alleged damages based on stock price declines.

A late-2008 impairment announcement by CBS Corp. provides an illustration. During 2008, the stock price of CBS declined considerably, falling almost 50 percent by Sept. 30, 2008.

On Oct. 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.”

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. Therefore, goodwill write-offs, if they occur, can be very significant.

In general, technology, media, energy 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.

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.

This article is intended to serve as a guide in providing background on goodwill impairments including their accounting standards, the SEC's current perspective on them, and other helpful information.

Goodwill Write-Off and Stock Price Decline

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 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 goodwill for impairment, the market capitalization of the firm is often considered relevant.

This is why the recent stock price declines are likely to lead to an increase in goodwill impairment tests, 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 is created when a firm acquires another enterprise or its assets and liabilities for a price that is in excess of the estimated fair values of the individual assets and liabilities acquired.

Accounting standard FAS 142[2] requires that fair values are first determined at the so-called reporting unit level 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. Goodwill thus essentially represents unidentifiable intangible benefits from acquisition.

As an illustration, goodwill may arise as a result of the "control premium" over fair values that a buyer would pay to get acquisition-related synergies.

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.

Such a test for goodwill impairment must be done 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."[3]

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.

Regulators Are Watching

The U.S. Securities and Exchange Commission has also said that it expects more goodwill impairment than usual due to the recent declines in stock prices.

In recent speeches, one SEC accountant said 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,"[4] and added that the SEC "would expect more goodwill impairment than in recent years ..." in the upcoming financial filings.

Another SEC accountant indicated that a "decline in market capitalization below book value," including the "duration and severity of [the] difference,"[5] would be an impairment testing indicator for goodwill, assuming factors such as short-term volatility are ruled out as the causes.

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.

Additionally, 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."[6]

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 2008 results for non-financial companies are reported, write-offs of goodwill, deferred tax assets and other non-current assets are likely to become more common than ever before. Understanding how they are accounted for and valued can prove helpful in avoiding legal issues down the line.

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[1] Fair value is defined as the price at which an asset can be sold or a liability can be settled.

[2] 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.

[3] FAS 142, para. 28.

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

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

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