

December 13, 2008

Goodwill Impairment Testing in Today's Economy

Given the recent downturn in the economy, there should be an increased focus by companies and their auditors on the evaluation of goodwill for impairment. FASB Statement No. 142, *Goodwill and Other Intangible Assets*, (FAS 142) requires that the impairment testing of goodwill be conducted in two steps. The focus of Step 1 is to identify potential impairment by measuring the fair value of the reporting unit and comparing such fair value to the carrying amount of the reporting unit, including goodwill. In the event the fair value of the reporting unit is less than its carrying amount, then the company must analyze and measure the goodwill impairment (if any) in Step 2. Otherwise, goodwill is not considered to be impaired and no further testing is required.

Reporting Unit Determination

A reporting unit is defined as an operating segment or one level below an operating segment (component). For public companies that are required to report operating segments under FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, (FAS 131), the operating segments determined based on FAS 131 is the starting point for determining reporting units. This does not necessarily mean, however, that the reportable operating segments will be the same as the reporting units used in the goodwill impairment testing. For example, the reportable operating segments may have been aggregated from a larger number of operating segments, which is allowable under FAS 131 when all the criteria for aggregation are met. When aggregation has occurred, it would not be appropriate to use the reportable operating segments as the starting point for the determination of the reporting units because the starting point should be the level below the reportable operating segment (*i.e.*, the operating segment). Furthermore, a component of an operating segment (the level below the operating segment) would be considered a reporting unit if it meets the definition of a business, discrete financial information is available and segment management regularly reviews the operating results of that component.

Fair Value of a Reporting Unit

Quoted market prices in active markets are the best evidence of fair value and should be used for a reporting unit in Step 1 if available. The market prices utilized may be as of the impairment testing date or may be an average over a reasonable period of time prior to the impairment testing date, but the methodology selected by a company must be applied consistently. The length of time considered "reasonable" is not defined, but we believe it should be framed in terms of days or weeks, not months. However, a reporting unit's market capitalization may not be truly representative of its fair value as a whole and therefore FAS 142 allows the use of control premiums (synergies and other benefits that flow from control over an entity) in addition to market capitalization when determining fair value for a publicly-traded reporting unit. The determination of an appropriate control premium is highly dependent on a company's specific facts and circumstances and generally requires the use of a valuation specialist. A control premium should not be determined generically based on rules of thumb or general references to industry standards. Furthermore, the level of evidence and documentation required to support the control premium utilized by a company should be commensurate with the control premium percentage. In other words, the greater the control premium utilized, the greater the level of evidence required to support that premium.

In addition to considering market capitalization plus an appropriate control premium when determining the fair value of a reporting unit, we believe, based on comments from regulators and others regarding the current environment of depressed equity valuations, public companies may also consider other valuation methods (which would be required if a public company has more than one reporting unit), such as a present value technique or other market approaches (*e.g.*, market comparable transactions, multiples of earnings/EBITDA etc). However, all valuation methods must be

appropriately weighted in determining the fair value of a reporting unit. It would be inappropriate to assign no weight to the value determined based on a company's market capitalization plus an appropriate control premium when determining the fair value of a reporting unit. If a present value technique is utilized, assumptions such as the discount rate should be appropriately calibrated to current market conditions and consistent with assumptions used in other areas (such as cash flow projections used when determining a deferred tax asset valuation allowance). Given the current market conditions, assumptions that are consistent with prior periods may not be appropriate. This applies equally to the use of market comparable transactions, which should only be utilized if there are recent transactions for similar businesses, as prices/multiples paid in transactions that occurred more than a few months ago are unlikely to be consistent with today's market.

Furthermore, although not explicit in FAS 142, practice has developed that a reconciliation to support the differences between the fair value determined based on market capitalization plus an appropriate control premium at the impairment testing date and fair values determined based on other valuation techniques should be performed. This is the case both for those companies with a single reporting unit and those with multiple reporting units. If a company's stock price is highly volatile and this volatility is in both directions (*i.e.*, not just a general downward trend with minor upswings), part of this reconciliation may consider a subsequent recovery of stock price (plus appropriate control premium) for a period of time after the impairment testing date. If the fair value determined by other valuation techniques is significantly different from a company's market capitalization plus an appropriate control premium, the models and assumptions used in those valuation techniques should be heavily scrutinized and challenged.

Step 2

To determine the amount of goodwill impairment, if any, Step 2 requires that a hypothetical purchase price allocation be performed. This hypothetical purchase price allocation requires the fair value of the reporting unit determined in Step 1 to be allocated to its identified assets (including intangible assets not recorded by the reporting unit) and liabilities. This purchase price allocation is equivalent to that required under paragraphs 37 and 38 of FASB Statement No. 141, *Business Combinations* (FAS 141), as if the reporting unit was acquired for a price equaling its fair value and will often require companies to

use an outside valuation specialist. The amount of goodwill determined in the hypothetical purchase price allocation (as a residual after the valuation of all other assets and liabilities) is considered the "implied" fair value of goodwill. If the carrying amount of a reporting unit's goodwill is greater than its implied fair value, an impairment charge must be recorded equal to the excess carrying amount. The following table can be used as a high-level guide for Step 2 goodwill impairment testing to understand the effect that increases or decreases to the carrying amount of assets and liabilities (in the hypothetical purchase price allocation) have on the implied fair value of goodwill and the potential goodwill impairment:

	FAS 141 Value Compared to Carrying Amount	Effect on Implied Fair Value of Goodwill	Likelihood of Goodwill Impairment
Assets (other than goodwill)	Greater	Decrease	Greater
	Less	Increase	Less
Liabilities	Greater	Increase	Less
	Less	Decrease	Greater

Note that the comparison of the value determined based on FAS 141 to the carrying amount above is merely hypothetical for purposes of the Step 2 goodwill impairment testing. A company should not adjust recognized assets or liabilities to the FAS 141 values or recognize previously unrecognized intangible assets at the FAS 141 value determined for the hypothetical purchase price allocation. However, if assets or asset groups within the reporting unit being tested for goodwill impairment are required to be tested for impairment simultaneously, these assets or asset groups should be tested for impairment first under other appropriate guidance. An impairment charge should be recorded, if necessary, prior to the goodwill impairment test being performed.

Generally, if a company fails Step 1 of the goodwill impairment test, a goodwill impairment charge will be recorded as a result of the Step 2 analysis. However, this is not always the case. For example, a company may have a long-lived asset with a FAS 141 value that is less than its carrying amount which is not impaired under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, (FAS 144) as it is considered recoverable due to the expected undiscounted cash flows exceeding the carrying amount. In this scenario, if a company narrowly failed Step 1, they either

may not have impairment to record or the impairment to record would be lower in Step 2 as the table shows above.

Frequency of Impairment Testing

Goodwill of a reporting unit must be tested for impairment on an annual basis and, in certain circumstances as discussed below, between annual tests on an interim basis. The annual goodwill impairment test may be performed any time during the fiscal year provided the test is performed at the same time every year.

Goodwill of a reporting unit must be tested for impairment on an interim basis if an event occurs or circumstances change that would more likely than not (a likelihood of over 50%) reduce the fair value of a reporting unit below its carrying amount. Examples of such events or circumstances noted in FAS 142 include:

- A significant adverse change in legal factors or in the business climate
- An adverse action or assessment by a regulator
- Unanticipated competition
- A loss of key personnel
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of
- The testing for recoverability under FAS 144 of a significant asset group within a reporting unit
- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

Goodwill must also be tested for impairment after a portion of goodwill has been allocated to a business to be disposed of.

Based on recent comments from regulators, additional examples of events or circumstances that may trigger the requirement for impairment testing between annual tests include:

- Recognition of a significant impairment charge or increase in valuation allowances
- Recent significant cash or operating losses with expectations that these losses will continue
- Weakness in the particular industry in which the reporting unit operates
- Inability to meet quarterly earnings estimates
- Restructuring plans.

Although not specifically mentioned as an example above, we also believe that a significant decline in the market capitalization of a reporting unit below its carrying amount may be an event or circumstance that triggers the requirement for impairment testing between annual tests. However, we do not believe that a reduction of market capitalization below book value is an automatic indicator. Given the recent volatility in the financial markets, companies should carefully consider whether their market capitalization has declined and if so, whether interim impairment testing is required because it is more likely than not that the reporting unit's fair value is less than its carrying amount. This applies to publicly-traded companies with single reporting units as well as those with multiple reporting units (in which case the aggregate carrying amount of the reporting units as a whole would be compared with the company's market capitalization). We recommend that companies develop policies to help in the evaluation of whether a decline in market capitalization triggers an interim impairment test. These policies are very important as they will be relied upon to help companies evaluate whether they are required to perform an interim impairment test. These policies should consider the following:

- The length of time for which a reporting unit's carrying amount has exceeded its market capitalization
- The significance of the amount/percentage by which a reporting unit's carrying amount has exceeded its market capitalization
- Whether a decline in market capitalization is attributable to one of the other events or circumstances noted previously, such as an adverse change in the business climate

Example wording that might be included in a company's policy could be one or a combination of the following phrases:

- If our market capitalization remains below the carrying amount of our sole reporting unit (or company as a whole if multiple reporting units) for two consecutive quarters, this is an indicator of impairment;
- If our market capitalization remains below the carrying amount of our sole reporting unit (or company as a whole if multiple reporting units) by greater than X% for any full quarter, this is an indicator of impairment

An example of a recent thorough disclosure discussing a Company performing an interim goodwill impairment test as a result of a depressed market capitalization is as follows:

The Company performed interim goodwill impairment testing at June 30, 2008 because its common stock had been trading below book value per share for three consecutive quarters. The estimated fair values of the three reporting units with goodwill (Corporate Finance, Trade Finance and Vendor Finance) were calculated based on observable market price-to-earnings multiples and tangible book value multiples of relevant, comparable peer companies. Commencing in the second quarter of 2008, management corroborated the estimated fair value of the reporting units based on multiple analyses with discounted cash flow analyses that indicated estimated reporting unit fair values consistent with the estimated reporting unit fair values developed using price-to-earnings and tangible book value multiples. Management determined that no goodwill impairment charge was required. Management will continue to monitor the relationship of the Company's market capitalization to both its book value and tangible book value, which management attributes to both financial services industry-wide and Company-specific factors, and to evaluate the carrying value of goodwill and other intangible assets.

While management has a plan to return the Company's business fundamentals to levels that support the book value per common share, there is no assurance that the plan will be successful, or that the market price of the common stock will increase to such levels in the foreseeable future. If the Company's common stock price continues to trade below book value per common share, the Company may have to recognize an impairment of all, or some portion of, its goodwill and other intangible assets. Price-to-earnings and book value multiples relating to the Company's reporting units have generally declined the past three quarters and discount rates used in cash flow analyses have increased. There is no assurance that: (1) valuation multiples will not decline, (2) discount rates will not increase or (3) the earnings, book values or projected earnings and cash flows of the Company's individual reporting units will not decline. Accordingly, an impairment charge to goodwill and other intangible assets may be required in the foreseeable future if the book equity value exceeds the estimated fair value of the enterprise or of an individual segment.

We believe that regardless of the date of a company's annual impairment test, if there is an impairment indicator identified any time prior to or after such date, Step 1 of the goodwill impairment test should be performed at that point. For example, if a calendar year-end company's annual impairment testing date is October 1, and an impairment indicator is identified during the quarter ending September 30, the company should not wait until October 1 to perform an impairment test. In the same scenario, assume that a company determined in December that they have an interim impairment indicator. Although this indicator occurred during the same quarter as the Company's annual impairment test, they would still be required to test goodwill for impairment in December, in addition to the annual test they already performed as of October 1.

Companies are reminded to begin the analysis of goodwill impairment early to allow sufficient time to complete Step 2 of the impairment test (should that become necessary) before the quarterly or year-end financial statements are issued. If Step 2 is not complete prior to the issuance of a company's financial statements and a goodwill impairment loss is probable and estimable, the best estimate of the loss should be recorded in the financial statements. Disclosure that Step 2 of the impairment test is not complete, the impairment loss recorded is an estimate and the reasons why the testing has not yet been finalized is required.

Nonpublic Companies

While the guidance discussed above focuses on public companies, it often is equally relevant for nonpublic companies. In particular, while nonpublic companies cannot determine the fair value of their reporting units based on a quoted market price and therefore do not have to reconcile fair value estimates to market capitalization, they are required to determine their fair value based on other techniques previously discussed. It is very important in the current environment that companies are diligent in preparing these valuations and calibrating the assumptions used to the current market conditions. The carryforward of a prior-year reporting unit valuation as allowed under FAS 142 is unlikely to be appropriate given the events and circumstances that have occurred recently in the marketplace.