A CAQ COVID-19 RESOURCE

Goodwill Impairment Considerations in the COVID-19 Environment

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The COVID-19 pandemic and the related market conditions create many new uncertainties for auditors, audit committees, investors and management of public companies. As SEC Chair Jay Clayton recently recognized, the continuing operation of the US capital markets is an essential component of our national response to, and recovery from, COVID-19. Goodwill balances are typically tested annually for impairment or when a triggering even occurs and when necessary, an impairment loss is recognized. Given the nature of goodwill as an accounting estimate, it is an account that can be impacted by volatile economic conditions. This resource is intended to provide a high-level overview of management's accounting requirements and auditor considerations for testing goodwill impairment in the COVID-19 environment.

This resource is intended as general information and should not be relied upon as being definitive or all-inclusive, or a substitute for PCAOB and SEC rules, FASB accounting requirements, standards, guidance, or other resources.

TECHNICAL REQUIREMENTS

For Management

In 2017, the FASB issued an Accounting Standards Update (ASU), *Simplifying the Test for Goodwill Impairment* (ASU 2017-14) which became effective January 1, 2020 for all calendar-year public business entities that do not meet the U.S. Securities and Exchange Commission (SEC) definition of a smaller reporting company.[1] The ASU amended the goodwill impairment test to simplify the accounting for goodwill impairment by removing the second step of the quantitative goodwill impairment test. This resource has been prepared based upon the amended requirements; however, even in situations where the new standard is not yet effective, this resource still may be useful in considering the impact COVID-19 may have on certain aspects of accounting for goodwill impairment, such as triggering event identification and reporting unit carrying value and fair value calculations.

Management is required to assess goodwill for impairment annually and when a triggering event occurs. For many companies, the impacts of COVID-19 could trigger the need for an interim goodwill impairment test. While not an exhaustive list, ASC 350-20 *Goodwill* states that the following may indicate that a triggering event has occurred and therefore, an interim impairment test may be needed:

a. Macroeconomic conditions, such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets.

b. Industry and market considerations, 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.

c. Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows.

d. Overall financial performance, such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods.

e. Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation.

f. Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

g. If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers).[2]

Goodwill is tested for impairment at the reporting unit level in accordance with ASC 280 *Segment Reporting*. If based on the triggering event analysis, it is determined that it is more likely than not (a likelihood of more than 50 percent) that the fair value of a reporting unit is less than it's carrying value, management will need to perform a quantitative or "step 1" goodwill impairment test.[3] In order to perform the quantitative goodwill impairment test, the carrying value and fair value are calculated for each reporting unit. If the carrying value of a reporting unit exceeds the fair value, a goodwill impairment charge is recognized equal to the difference between the fair value and carrying value.

The annual impairment test date is the same date each fiscal year and each reporting unit is evaluated for impairment using the qualitative or quantitative

1 See ASU 2017-14.
2 See ASC 350-20-35-3C.
3 ASC 350-20-35-3E.

approach. The qualitative or "step 0" approach considers factors, such as the triggering event factors discussed above, which may indicate that a reporting unit is impaired, or it's carrying value exceeds its fair value. If based on this qualitative analysis it is determined that it is more likely than not that this reporting unit is impaired, the company is required to perform a quantitative assessment.[4] It is important to note that the entity has an unconditional option to bypass the qualitative assessment for any reporting period or any reporting unit and proceed directly to performing the quantitative analysis.[5] In light of the COVID-19 circumstances, companies may decide to skip step 0 and proceed to step 1.

Carrying value considerations

A reporting unit's carrying value is equal to its net assets.[6] Before evaluating goodwill impairment, it is important to consider impairment of all other assets such as plant property and equipment, inventory, trade accounts receivable, right-of-use assets, and equity method investments. Impairment of other asset types should generally be completed and reflected in the carrying values in the reporting unit prior to the goodwill impairment test.

Fair Value Considerations

Step 1 of the goodwill impairment test requires the company to determine the fair value of the reporting unit. Fair value of the reporting unit should be calculated in accordance with ASC 820 *Fair Value Measurement*, which provides three valuation approaches:

1. **Market approach:** A valuation approach that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business.[7]

2. **Cost Approach:** A valuation approach that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).[8]

3. **Income approach:** A valuation approach that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business.[9]

When determining which valuation approach is most appropriate to use, management should consider whether there is adequate data available. For example, management may determine there is not sufficient data available to apply the market approach as a similar transaction has not occurred in a comparable economic environment. Management may also determine that it is appropriate to use a combination of valuation techniques and determine the reporting fair value based on a weighted average of each of the fair value calculations.

Each of these valuation approaches requires significant management judgment and valuation expertise. The key assumptions in these models often involve forward looking information such as forecasted future revenues, earnings before interest, taxes, depreciation and amortization ("EBITDA"), and capital expenditures. Management will need to involve the appropriate finance and operations personnel in the review and preparation of these amounts to validate the appropriateness of these forecasted amounts. Additionally, these models also involve valuation specific inputs such as discount rate and weighted average costs of capital. Management should assess if they have the appropriate expertise to evaluate these assumptions, or if they should engage a specialist to assist with the selection and application of these fair value models. If management does

4 ASC 350-20-35-3E.
5 See ASC 350-20-65-3
6 See ASC 350-20-35-38 – 44 for guidance on determining the reporting unit carry values.
7 See ASC 820-10-20 Glossary.
8 See ASC 820-10-20 Glossary.
9 See ASC 820-10-20 Glossary.

engage a specialist, they should work closely with them to ensure the model used by the specialist is appropriate, taking into account the requirements of the applicable financial reporting framework (e.g. ASC 820) and the assumptions are appropriate based on management's deep knowledge of the company and industry.

Internal Control Considerations

Under the Sarbanes-Oxley Act of 2002 management is required to assess the effectiveness of their internal controls over financial reporting. Specific to goodwill impairment, management will need to assess if they have the appropriate controls in place to address the risks associated with each step of goodwill impairment testing including: triggering event considerations, carrying value and fair value calculations (if a quantitative goodwill test is performed) and, if applicable, the impairment charge calculation. While there have been no changes to these requirements, management should consider if their internal controls are appropriately designed and operating at a precise enough level to detect a material misstatement in the current environment. It may be appropriate to alter the design of certain controls or create new controls due to the COVID-19 environment presenting new risks. For example, management may determine it is appropriate to use a specialist in their goodwill impairment analysis due to the volatile environment. If management has not historically involved a specialist in this process, they will want to review their controls and update them to incorporate the appropriate oversight and reviews of the specialist's work including whether the model used by the specialist is appropriate for the financial reporting framework.

For Auditors

In 2018, the PCAOB adopted a new auditing standard *Auditing Accounting Estimates, Including Fair Value Measurements* (AS 2501)[10] that takes effect for audits of fiscal years ending on or after December 15, 2020. The PCAOB amended AS 1105, *Audit Evidence* to add a new *Appendix A, Using the Work of a Company's Specialist as Audit Evidence* and added new paragraph .28A AS 2110. The PCAOB also amended AS 1201, *Supervision of the Audit Engagement*, by adding a new *Appendix C, Supervision of the Work of Auditor-Employed Specialists* and replaced AS 1210, *Using the Work of a Specialist*, with a new AS 1210, *Using the Work of an Auditor-Engaged Specialist*. These amendments will also be effective for audits of fiscal years ending on or after December 15, 2020. This resource has been prepared based upon the amended and new requirements for auditing accounting estimates and using specialists; however, even in situations where the new standards are not yet effective, this resource still may be useful in considering the impact COVID-19 may have on certain aspects auditing goodwill impairment, such as assessing management's triggering event evaluation and carrying value and fair value calculations.

COVID-19 CONSIDERATIONS FOR AUDITORS

Auditing goodwill for impairment is a complex process and involves performing procedures over the existence of an impairment triggering event, carrying value of the reporting unit(s), the calculation of fair value, and the impairment loss (if applicable). In addition, auditors will evaluate the design and, when applicable, operating effectiveness of management's controls over the goodwill impairment. COVID-19 could result in auditors being required to perform additional or different procedures over goodwill balances and disclosures than they would have in a more stable economic period. Auditors may want to consider the below when evaluating goodwill in the current COVID-19 environment.

Triggering Event Considerations

COVID-19 has resulted in a declining economy hitting virtually every industry. For some companies, this may indicate that it is more likely than not that the carrying value of the reporting unit exceeds the fair value. In evaluating the company's assessment, auditors may have to perform additional or different procedures than they have in the past. When performing this interim analysis, auditors may consider the following:

- Do the circumstances as outlined in ASC 350-20-35-3C indicate that it may be more likely than not

10 See AS 2501.

that a reporting unit's carrying value exceeds its fair value?

- If no, has management appropriately documented any negative factors that may impact the fair value of the reporting unit and does the documentation support their conclusion?

- If management determines an interim impairment test is not needed, is there contradictory evidence such as declining analyst projections; sustained decrease in stock price, or reported earnings below forecasted amounts that may suggest otherwise?

Carrying Value Considerations

If the company determines a triggering event has occurred, or if they perform a quantitative goodwill impairment test as part of their annual goodwill assessment, auditors will need to assess management's reporting unit carrying value calculation. As such, auditors may consider the following when auditing reporting unit carrying value:

- Has management considered the impairment of all applicable asset groups and has management updated reporting unit carrying values to reflect impairment of other asset types?

Fair Value Considerations

While auditing fair value is typically a complex area, the uncertainty of the extent and duration of the pandemic has added an additional layer of complexity to reporting unit fair value calculations. The Center for Audit Quality (CAQ) recently released, *Auditing Accounting Estimates in the COVID-19 Environment*, which provides a high-level overview of auditor's responsibilities related to the auditing of estimates and highlights COVID-19 related considerations. Refer to that resource for an overview of auditing accounting estimates, such as reporting unit fair value, in the COVID-19 environment. Specific to reporting unit fair value calculations, auditors may want to consider the following:

- Does management have the appropriate expertise, or have they involved a third-party expert to assist with the fair value calculation?

- Has management appropriately considered the current uncertain environment in their valuation model?

    - Are their assumptions such as budgets, forecasts, discount rates, etc. reflective of the increased risk and uncertainty?

    - Has management considered all appropriate available evidence to reach their conclusions (e.g., have they employed modeling multiple scenarios to incorporate the uncertainty of the future? have they performed a sensitivity analysis over significant assumptions? did they document their basis for selection of assumptions when a range of outcomes was developed?)

    - Did management consider any contradictory evidence in the model?

- Does the fair value of all reporting units reconcile back to the market cap? If not, did management make adjustments to show the differences between these amounts and are the adjustments reasonable?

- What substantive testing approach as described in AS 2501 is most appropriate given the facts and circumstances of the audit client?[11]

- Is it necessary for the audit team to engage a valuation specialist to assist in evaluating complex assumptions?

Internal Control Considerations

Goodwill impairment testing involves multiple steps and often, complex calculations that involve management judgment. Auditors will need to assess if management has the appropriate controls in place to cover each step of goodwill impairment. Particularly in the COVID-19 environment, auditors may want to consider the following when evaluating management's controls over goodwill impairment:

11 See AS 2501.07

- Has management appropriately adjusted their internal controls for a remote work environment?
- Has management appropriately considered COVID-19 implications in each step of their goodwill impairment testing? (e.g., in carrying value calculations, did management consider the impact from the impairment of other asset groups? in fair value calculations, has management considered the sensitivity of inputs?)
- Has management appropriately overseen the work of any third-party specialists they have engaged?
- Does management have effective controls over the data used within this assessment (e.g., controls over forecasted financial information)