

Minimizing goodwill impairment differences globally: No fast or simple solution



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Executive summary

A crucial exercise for acquisitive businesses is to routinely assess the goodwill booked in an acquisition to determine whether there has been any impairment and, if so, how much. Why? Because inaccurate goodwill accounting can:

- Distort financial reporting, potentially leading investors and analysts to lose confidence in the company.
- Cause a company's stock price to plummet.
- Expose the company and its executives to potential legal, regulatory, and reputational risks.

As discussed in the first article in this series, "[The goodwill impairment dilemma: What happens when U.S. GAAP and IFRSs clash?](#)," particular challenges can arise in goodwill impairment valuation and accounting when a company acquires a business located in another country. Differing goodwill accounting standards, such as those under U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRSs), can create some disparities between write-offs taken in one

country versus another country, but if those standards are applied rigorously, the differences should be minimal.

However, it is apparent that in recent years there have often been notable differences in goodwill impairment conclusions across the world. So what is the root cause or causes of these differences? Is it varying valuation practice due to the lack of consistent global standards or the different stages of development of the valuation profession globally? Is it cultural or language differences? Is it inconsistent application of the accounting and auditing standards? Or maybe it is all of the above, as well as other factors that are unclear at this stage. In this paper, we explore some of these issues for insights.

What is clear is that regulators around the world, along with accounting and valuation industry leaders, are taking steps to bring more clarity and consistency to goodwill impairment valuation and accounting. As the global landscape evolves, company executives can benefit from understanding some important factors that may have led to differences in the assessment of goodwill impairment across countries. It will also help to understand activities that are under way in various areas of the world to improve the reliability of goodwill accounting information and also to bring greater consistency to the activities underpinning goodwill conclusions and disclosures.

Potential impacts of goodwill impairment announcements

Two recent situations highlight the potential financial impact of goodwill impairment announcements on a company's stock price, particularly when information provided is either perceived to be late in coming, uninformative, or potentially misleading about the reasons for impairment.

In early 2013, New York-based Lakeland Industries Inc., an industrial protective clothing manufacturer, announced it had recorded an impairment charge of \$9.8 million against goodwill and intangible assets in its Brazilian subsidiary at year end. The company said it had determined that the carrying amount of goodwill related to the subsidiary exceeded its fair value following a fourth-quarter operating loss, and it warned of a potential default on a bank line of credit. Following the news, the company's shares fell more than 23 percent.¹

Such a statement can be unintentionally misleading, and it also revealed a misunderstanding of valuation. Valuation is a forward-looking exercise, so experiencing an operating loss in the period leading up to a goodwill impairment is not a reason for the impairment itself. The operating loss may be the precursor to an extended period of below-par performance, but it is the future outlook of the subsidiary's business that is the important aspect.

The significant company stock price decline also revealed the market's reaction to such an announcement. Potential downturns in business fortunes rarely occur overnight, and a delayed announcement of a goodwill impairment probably gave the market far greater information to react to than the impairment itself. If appropriate and timely information is supplied to investors, a goodwill impairment is typically not seen as a notable event.

If timely information is not supplied to the marketplace, it can bring into question whether a company's internal controls are effective, which is an increasing concern of auditors and regulators. The goodwill impairment accounting standards call for regular monitoring of factors that might indicate possible impairment and require an interim test. If such interim tests are not performed, or are performed but there is a lack of disclosure regarding the potential for a future goodwill impairment, and if a late announcement and write-down of goodwill occurs, then an associated large stock price drop could mean there was a period of time leading up to the decline where the stock price was inappropriately high.

¹ <http://www.rttnews.com/2074526/lakeland-sees-brazil-operating-loss-impairment-charge-stock-down-23.aspx>.

Italy's largest phone company, Telecom Italia SpA, reported a 2012 loss after taking a larger-than-expected goodwill write-off of more than 4 billion euros (\$5.2 billion). The company announced dividend cuts and potential asset sales, and Chief Executive Franco Bernabe said the goodwill write-down "was made necessary by the persisting recessionary tensions and the challenging global macroeconomic climate." However, Bernabe claimed that the write-down would only have an accounting effect,² an assessment that some people would disagree with. As Stefano Vulpiani, an analyst at Istituto Centrale delle Banche Popolari Italiane SpA, suggested at the time, "The market is probably ready to reconsider the value of Telecom Italia's shares."³ The stock market did indeed ratchet down Telecom Italia's stock price in the weeks leading up to the impairment announcement in early 2013.⁴

These are not isolated examples, and cases like these are a harsh reminder that goodwill impairment is not merely an "accounting issue." In particular, delayed or limited insights into a potential impairment, the reasons for taking an impairment, or inaccurate or inconsistent reporting of goodwill impairment can have regulatory, legal, and reputational consequences that potentially can cause real harm to a company, its executives, and its shareholders.

Growing scrutiny and enforcement

Recent actions taken by regulators reflect their growing concern over diverse practices and goodwill impairment results. For example, the International Forum of Independent Audit Regulators (IFIAR) and the European Securities and Markets Authority (ESMA) are working to increase the rigor of global and European practices, respectively, in this area, similar to the focus in the U.S. provided by the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) in recent years.

In December 2012, IFIAR released its first global survey of audit inspection findings. The survey results indicated that the largest number of inspection findings in audits of public companies occurred in fair value measurements, internal control testing, and engagement quality reviews.⁵

² "Telecom Italia Posts Net Loss On Goodwill Writedown," Manuela Mesca, 4-traders.com, March 7, 2013, <http://www.4-traders.com/TELECOM-ITALIA-SPA-102978/news/Telecom-Italia-SpA--Telecom-Italia-Posts-Net-Loss-On-Goodwill-Writedown-16511362/>.

³ "Telecom Italia Posts 1.6 Billion Euro Loss After Writedown," Daniele Lepido, Bloomberg, March 8, 2013, <http://www.bloomberg.com/news/2013-03-07/telecom-italia-s-2012-loss-narrows-writes-down-goodwill.html>.

⁴ <http://www.bloomberg.com/quote/TIT:IM>.

⁵ [https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR-2012-Summary-Report-of-Members-Inspection-Findings-18-Dec-12-\(2\).pdf](https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR-2012-Summary-Report-of-Members-Inspection-Findings-18-Dec-12-(2).pdf).

Notwithstanding the fact that many audits do not show evidence of any deficiencies, the areas mentioned above are topics that, particularly if occurring together, can lead to inconsistencies in conclusions in the area of goodwill impairment testing.

In addition, in a press release, IFIAR Chair and Executive Director of Conduct at the UK's Financial Reporting Council called on audit firms to "...do more to improve the consistency of performance on individual audit engagements..."⁶

In January 2013, ESMA reported on its review of accounting practices related to impairment testing of goodwill and other intangible assets under International Accounting Standard (IAS) 36, *Impairment of Assets*. According to the report, which reviewed 2011 data:

"Although the major disclosures related to goodwill impairment testing were generally included, in many cases these were of a boilerplate nature and not entity-specific. This stems from a combination of a failure to comply with the requirements of the standard by issuers, as well as, arguably, a lack of specificity in the standard, especially in the area of sensitivity analysis. This also means that, in many cases, the user of the financial statements is not able to evaluate the reliability of the assumptions used from the disclosures given, which is the primary purpose of those disclosures."⁷

Additionally, "ESMA and national competent authorities responsible for IFRS enforcement will use the review's findings as areas to focus their assessments on when reviewing 2012 IFRS financial statements. ESMA hopes this will lead to an improved rigour applied by issuers in the impairment test of goodwill and a better compliance with the requirements regarding impairment in IAS 36 *Impairment of Assets*."⁸

⁶ IFIAR releases first global survey of audit inspection findings, press release, December 19, 2012, <http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/December/IFIAR-releases-first-global-survey-of-audit-inspec.aspx>.

⁷ "ESMA Report, European enforcers review of impairment and goodwill and other intangible assets in the IFRS financial statements," European Securities and Markets Authority, January 7, 2013, <http://www.esma.europa.eu/system/files/2013-02.pdf>.

⁸ <http://www.iasplus.com/en/news/2013/01/esma-report-on-disclosures-related-to-goodwill-impairment>.

Be aware of more intense enforcement actions

Increasingly, regulatory bodies, particularly in the U.S. and Europe, are focusing attention on the effectiveness of companies' financial reporting on, and rationale for, why goodwill is not impaired. For example, in recent comment letters to both U.S. registrants operating under U.S. GAAP and Foreign Private Issuers (FPI) that operate under IFRSs, the SEC made strong statements about its expectations for "accurate and timely" reporting of goodwill impairment, especially relating to estimation of fair values:

- In one case involving a U.S. registrant, the SEC staff commented on the registrant's compliance with the disclosure requirements in Regulation S-K, Rule 303(a)(3)(ii) to discuss a known uncertainty — specifically, to disclose the potential for a "material impairment charge." The SEC has noted that it may use these disclosures to assess whether a registrant's goodwill impairment analysis is reasonable or whether the registrant should have performed an interim goodwill impairment analysis.⁹
- To one FPI, the SEC staff commented: "We note that you recorded a material goodwill impairment charge... In light of the impact of this charge, please revise future filings to explain in more detail the events and circumstances that led to the impairment at the specific cash-generating units that were impacted. Your current disclosure ... does not appear to provide your investors with sufficient detail to allow them to assess the likelihood of similar future impairment charges."¹⁰

Clearly, the SEC staff continues to focus on the timing and robustness of disclosures about goodwill impairment and early warning disclosures.

Similarly, ESMA is clear about the enforcement priorities it intends to carry out in conjunction with national competent authorities.

*"ESMA expects issuers and their auditors to consider findings of this review when preparing and auditing the IFRS financial statements. ESMA expects national competent authorities will take or have already taken appropriate enforcement actions whenever material misstatements are identified and will actively monitor the progress of those actions. As indicated in the European common enforcement priorities, ESMA will collect data on how European listed entities have applied IFRS requirements in this area and will further report on its findings."*¹¹

⁹ "SEC Comment Letters — Including Industry Insights Highlighting Risks," Deloitte, November 2012, p39.

¹⁰ *Ibid*, p63.

¹¹ "ESMA Report, European enforcers review of impairment and goodwill and other intangible assets in the IFRS financial statements," European Securities and Markets Authority, January 7, 2013, <http://www.esma.europa.eu/system/files/2013-02.pdf>.

Why differences arise

The goodwill impairment tests conducted under U.S. GAAP and IFRSs are mechanically different. However, contrary to what many may think, the impairment conclusions reached under each should not necessarily vary dramatically if the respective standards are applied with rigor. Other factors *can and do* cause different conclusions. Key influences include the consistency of the valuation, accounting, and auditing analyses.

Various factors can also affect the quality of conclusions reached. For instance:

- In some countries, due to the absence of a robust valuation profession, the accounting profession may create valuation guidance despite the lack of formal valuation training, certification, or experience.
- Regulations may mandate use of highly prescriptive road maps for conducting impairment analysis, which can run counter to more market-based valuation approaches.
- Valuation guidelines may be published only in a native language and therefore could create a potentially significant barrier to clear interpretation of requirements or comparison or convergence with guidance in other jurisdictions.

Valuations performed for entities that operate in countries that have not historically had market-based economies face an additional hurdle because without market information, valuations relying on asset-based approaches or present value techniques will be challenged in their ability to provide a supportable conclusion for fair value or value-in-use.

This might lead the casual observer to assume that such issues arise only in “emerging markets.” Yet while certain areas of the world have significant valuation leading practice efforts that have been occurring in recent years that help the drive toward less diverse practice — for example, in the U.S. and Canada — many countries and regions across the world are only now starting such efforts. In the business valuation specialty, which is the main specialty necessary in goodwill impairment analysis, many countries and regions of the world do not have a professional body to help drive high-quality analysis, as well as a marketplace expectation of such.

However, fair value in financial reporting and related measures, such as value-in-use, have only come to the forefront in the last decade. IFRSs were widely adopted in Europe in the mid-2000s, and then gradually in many other regions across the world. At the same time, the global financial crisis occurring in tandem with new fair value literature caused even more complexity.

With varying economies and cultures contributing to

diverse professional environments across the world, diversity in practice was virtually inevitable. In fact, the move to IFRSs in many countries and a common fair value framework across both U.S. GAAP and IFRSs has perhaps exposed the diversity in the application of the literature that exists.

Gradually, however, individual countries — for example, Italy, as discussed below — are beginning to establish organizations that have support across a spectrum of stakeholders, and they are raising the bar in this arena, thus gradually decreasing the diversity in practice that exists. In other countries, ad hoc “special interest groups” are coming together to drive activities aimed at decreasing individual country diversity in practice.

Improving the landscape

Decreasing diversity of practice is obviously as important as leveraging efforts to develop and share leading practices and make those who apply them accountable for their application. Although there is much to be done, there is also much happening around the world on this topic.

Italy provides a notable example of significant national progress. Working together, the country’s accounting profession, Bocconi University, and other stakeholders created the Organismo Italiano di Valutazione (OIV) — the Italian valuation standard setter. On May 27, 2013, the OIV published the English translation of a document presenting valuation “best” practices adopted by major Italian-listed companies; a development that may have contributed to an increase in impairment transparency in financial statements (the draft document was initially issued in Italian in December 2011 under supervision of the Commissione Nazionale per le Società e la Borsa — the Italian equivalent of the U.S. SEC — and finalized on June 14, 2012).¹² Comparing 2010 “pre-best practice” figures to data from 2011, after the guidance issuance, cumulative impairment/gross goodwill among Italian companies rose from 2.9 percent to 24.7 percent. Clearly, such a change is not attributable solely to the guidance published.¹³ However, the document and its wide acceptance in the marketplace are major contributory factors.

The joint efforts of Italy’s valuation and accountancy professions, academia, regulators, and other interested parties in producing guidance for goodwill impairment analyses is a notable achievement. In establishing leading practices, the OIV publication has raised awareness of the importance of the valuation discipline and the expectation that leading practices will be followed.

¹² “Goodwill Impairment Testing in a Time of Economic and Financial Crisis,” Organismo Italiano di Valutazione, June 14, 2012.

¹³ “Old and New Issues in Business Valuation,” presentation by Mauro, Bini at 2012 OIV Business Valuation International Conference, slide 15.

In November 2011, the American Institute of CPAs (AICPA) issued a working draft, *Accounting and Valuation Guide Testing Goodwill for Impairment*, to offer guidance and illustrations for valuation specialists, financial statement preparers, and independent auditors.¹⁴ The AICPA Impairment Task Force that worked on the draft release comprises specialists in valuation and accounting from major U.S. firms. The final document is eagerly anticipated in the U.S. marketplace and will include guidance relating to the U.S. GAAP Optional Qualitative Assessment, which was introduced during the document's exposure period and is now incorporated in FASB ASC 350-20.

Additionally, the Appraisal Foundation's June 2013 Business Valuation Roundtable in Washington, D.C., focused on fair value and financial reporting, with emphasis on valuation standards, qualifications, and oversight, including the auditor and client perspectives.¹⁵

Goodwill impairment assessments require specialized valuation knowledge and skills. Valuation guidance and competence understandably varies from country to country and region to region around the world. The International Valuation Standards Council (IVSC) is increasingly addressing the need to strengthen and heighten the profile of the valuation profession worldwide by developing and supporting the adoption and use of high-quality international standards (the International Valuation Standards available at ivsc.org) and promoting the development of the valuation profession around the world.

The IVSC promotes collaboration and cooperation among its many member organizations and other international stakeholders, and serves as a voice for the valuation profession globally. In August 2013, the IVSC issued a paper describing its early discussions on the development of high-quality professional standards for professional valuers¹⁶ and inviting public comment about the undertaking of this major initiative. The standards will reflect "good practice in the education, training, and assessment of professional valuers that will act as international benchmarks."¹⁷

Important implications

ESMA's IAS 36 report, mentioned previously, aims at influencing the production of financial statements that provide investors with consistent, reliable, and relevant information. The data residing on a company's financial statements does not occur easily as a product of a unified global financial reporting framework. Rather, consistent application of global standards — valuation, accounting, auditing, regulatory, professional, and ethical — are all needed. As discussed above, a lot of work is still required for this to be achieved.

What of possible future developments? Do the generally higher levels of U.S. goodwill impairment write-offs in recent years relative to countries under IFRSs mean that the U.S. marketplace, and particularly the regulatory system, is pushing too hard and putting U.S. companies at a competitive disadvantage in the global economy? Should higher impairments be seen as an indicator that U.S. companies have made more "bad acquisitions" than companies elsewhere in the world or been more acquisitive? Or is it just reflective of a highly scrutinized market-based environment trying to ensure financial statements are appropriately stated after the corporate scandals of the early 2000s?

These questions are not easily answered. However, academia is increasingly studying this area, and these and other such questions may likely be interesting topics for further exploration.

Here are some additional considerations:

- Goodwill impairment assessment is not just an accounting exercise, or attributable only to historical events.
- Valuation is a forward-looking exercise and an impairment of goodwill often means future expectations are not as rosy as they were originally.
- The market punishes poor disclosure or late write-offs with no prior warning signals because it may communicate as much about company management performance as it does about the company's financial expectations.
- Reporting entities' use of valuation specialists in goodwill analysis is very inconsistent around the world. Equally, auditors' use of internal fair value specialists in the audit of goodwill analysis is not universal. Companies and auditors may benefit from increasing the use of valuation specialists in both of these arenas to increase the reliability of goodwill reporting and financial statement disclosures.
- IFRSs have been more widely adopted outside Europe only in recent years, making significant diversity in goodwill assessment practices and outcomes

¹⁴ "Goodwill Impairment Guide Released for Feedback, *Journal of Accountancy*, November 4, 2011, <http://www.journalofaccountancy.com/Web/20114729.htm>.

¹⁵ Commercial Appraiser-Appraisal Blog, May 13, 2013, <http://commercialappraiser.typepad.com/blog/2013/05/cre-cgrea-commercial-appraiser-fw-business-valuation-roundtable-june-13-2013-register-today.html>.

¹⁶ "Proposal to Develop International Professional Standards for Professional Valuers," IVSC, August 2013, <http://www.ivsc.org/sites/default/files/Discussion%20Paper%20International%20Professional%20Standards%20final.pdf>.

¹⁷ IVSC E-news, August 2013, <http://www.ivsc.org/content/august-2013-issue-57>.

highly likely, but as yet, less visible in other regions. Poor financial reporting disclosures can result from many things, including lack of resources, limited or nonexistent examples of leading practices, and the desire to not inform. These factors should be considered by executives, especially when evaluating M&A transactions across borders.

- When acquiring an entity that has itself made acquisitions historically, heightened skepticism about goodwill disclosures and goodwill impairments may be prudent. Also, be cognizant of country by country and U.S. GAAP versus IFRSs differences.
- The increased transparency and reliability of U.S. financial reporting resulting from a decade of PCAOB scrutiny is not occurring at the same rate elsewhere in the world. When making an acquisition, be aware of the particular regulatory environment that exists in the country where the target company has operations.
- Much has been achieved globally since the report, highlighted in the sidebar below, was released, but on a complex topic across the financial sector, much still needs to be done. Goodwill impairment, as has been discussed, is one area within financial reporting to which the report's fifth recommendation speaks loudly.

Setting the course for impairment valuation

The need for reliable and supportable goodwill impairment analysis and disclosure is growing as global commerce and cross-border acquisition activity expand. While regions and countries are at different stages of maturity in valuation and goodwill impairment accounting and auditing practices, advancements in regulatory oversight and cooperation in different areas point to the continuing evolution and improvement of this important activity. Can more be done? Yes.

First, the various stakeholders involved in each geographic region can elevate their awareness of the need for a higher level of valuation performance. Second, public company management should consider the risk reduction benefits of involving valuation specialists in their decision making and reporting. Audit firms can do the same in their audit of fair value estimates and related measurements. Finally, regulators in each region can influence the environment by recognizing the need for, and encouraging the use of, valuation specialists by both public companies and their auditors.

Increasingly widespread efforts by many in the valuation community to build a cohesive valuation profession globally can be supported by the various stakeholders as well. Such a concerted effort should be welcome news to investors, executives held accountable for a company's stock market performance, and regulators.

About Greg Forsythe

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The foregoing discussion of the different stages of evolution of the global environment with respect to goodwill impairment analyses and disclosures is very reflective of the broader topic of "Regulatory Convergence in Financial Professional and Industries" discussed in the Private Sector Taskforce of Regulated Professions and Industries Final Report to G-20 Deputies in September 2011. This substantive report in the wake of the financial crisis aimed to present to the G-20 a set of recommendations concerning the manner in which regulatory convergence in a number of professions and industries that fall within the financial sector may be achieved. The report's fifth recommendation was "to encourage and support the development, adoption, implementation and consistent interpretation of globally accepted high-quality international standards, to the greatest extent possible, for each of financial reporting, auditing, valuation, and actuarial services."

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