Deloitte.

The goodwill impairment dilemma: What happens when U.S. GAAP and IFRSs clash?

For acquisitive companies, determining whether goodwill booked in transactions has become impaired and if it has, by how much, is now a fairly regular occurrence. However, the accounting involved can be anything but straightforward when the acquirer is a U.S.-based company and subsidiary businesses are located elsewhere or vice versa.

Differences in the goodwill impairment standards under U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRSs) may create significant disparities as to whether goodwill is viewed as impaired and, if so, how much is written off in the United States and the other country, or even country-to-country. Other factors creating such disparities include the varying application of valuation methodologies, and historical cultural differences in the application of impairment accounting.

Such situations may be especially troublesome for U.S. businesses because of country-to-country differences around the world. For example, a U.S. company with operations in Germany, France, Spain, and Greece may write off goodwill entirely on a consolidated basis under U.S. GAAP. However, when a corporate life event, such as a spin-off or carve out, is undertaken related to the subsidiary outside of the U.S. depending on how the IFRSs principles are applied, some or none of its goodwill might be written off. (See: The U.S. GAAP-IFRSs dilemma: A case study).

Sorting out these differences may be a challenging process for management of companies operating in numerous countries across the world, when U.S. GAAP, IFRSs and potentially other financial reporting frameworks need to be addressed. Relief from the dilemma of distinguishing between the treatment under U.S. GAAP and IFRSs does not appear to be on the way any time soon. On one hand, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) are continuing their now decade-long work to converge IFRSs and U.S. GAAP. However, converging goodwill impairment accounting does not appear to be a near-term project. In addition, on July 13, 2012, the U.S. Securities and Exchange Commission (SEC) issued its final staff report on the "Work Plan for Consideration of incorporating IFRSs into the Financial Reporting System for U.S. Issuers" without offering a timetable for potential U.S. adoption of IFRSs for domestic filers.[1]

[1] The SEC's "Work Plan for the Consideration of Incorporating International Financial Reporting Standards Into the Financial Reporting System for U.S. Issuers." July 13, 2012.

This leaves companies for the foreseeable future still facing difficult situations when dealing with disparities such as goodwill impairment. This white paper, the first in a Deloitte[2] series, explores at a high level the challenges companies may face in performing goodwill impairment testing both in the United States and around the world. Subsequent papers will consider in more detail some of the reasons for the differences that may surface in how goodwill impairment is treated under different accounting standards in different countries, giving company management the opportunity to be informed about the issues that may arise in dealing with their impact.

The conceptual foundation of impairment issues

The differences in U.S. GAAP and IFRSs goodwill impairment treatment flow largely from a fundamental difference in accounting approaches. As a principles-based accounting approach, IFRSs provide a conceptual basis for accountants to follow in a one-step test that has both a fair value and an asset-recoverability aspect. U.S. GAAP, on the other hand, dictates that goodwill is tested for impairment through a two-step, fair value test with the level of impairment, if present, determined in Step 2 after an extensive analysis of related asset values. However, the FASB's recent issuance of a "step zero" qualitative assessment for goodwill impairment testing did introduce an element of a principles-based approach under U.S. GAAP.[3] Principles-based standards allow accountants to apply significant professional judgment in assessing a transaction. This is substantially different from the underlying "box-ticking" approach historically common in rules-based accounting standards.

The lack of precise guidelines in a principles-based approach may create inconsistencies in the application of standards across organizations and countries, particularly in a very subjective area such as fair value. On the other hand, rules-based standards can be viewed as insufficiently flexible to accommodate a topic such as fair value, which often requires significant professional judgments gained through experience, with extremely limited market data.

However, the U.S. has gradually been embracing the principles-based approach. The recently converged standards on fair value measurement (IFRS 13 and ASC 820), an IASB-FASB joint effort, supports this.

Even though the SEC has not set a timetable for if, when, or how the U.S. might move to IFRSs in the future, convergence efforts themselves in recent years have started to influence how new accounting standards are applied in practice.

U.S. GAAP-IFRSs dilemma: A case study

The experience of a U.S.-based consolidated company comprising six Reporting Units (RUs) demonstrates how differences in U.S. GAAP and IFRSs may affect goodwill impairment. The company was considering a spinoff of an RU located in a country following IFRSs, as a standalone company through an IPO. Therefore, a standalone audit of the RU was necessary under IFRSs. At the end of its fiscal year, the U.S. consolidated company wrote off the goodwill in its foreign-based RU and some other domestic RUs under U.S GAAP.

Outside the U.S., meanwhile, the subsidiary—a standalone RU in the U.S. and a single Cash Generating Unit (CGU) under IFRSs—performed an independent goodwill impairment analysis. The standalone CGU management did not believe there should be a goodwill write-off under IFRSs guidelines and following typical valuation procedures in that country related to goodwill impairment testing. As a result, the standalone CGU reported goodwill under IFRSs but the standalone RU under U.S. GAAP wrote the entire amount off, at the same point in time.

Addressing the dilemma

In a world where investors often react to new or inconsistent financial information within seconds, it is important for company management to understand environments where different conclusions may be reached relative to topics such as goodwill impairment.

Sometimes differences need to be addressed and initial conclusions potentially modified. In other situations differences are just the result of the various financial reporting frameworks and environments across the world. However, it is important to be aware that situations may occur where various parties involved may not agree or understand each other's perspectives, and then be able to navigate them effectively to get to supportable and reasonable conclusions.

Understanding real differences due to statutory guidance—such as non-convergent accounting versus interpretations of principles-based standards, or the varying application of valuation methods—is extremely important.

[2] As used in this document, "Deloitte" means Deloitte LLP and its subsidiaries. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

[3] ASU 2011-08 Intangibles Goodwill and Other (Topic 350) introduced and optional qualitative assessment for testing goodwill for impairment.

The effects of culture and translation

As accounting standards, IFRSs are still relatively recent, with European nations as early adopters in 2005; although, in some countries, IFRSs have been around longer. Numerous countries around the world have been transitioning to IFRSs in recent years. In many of those countries, fair value was not present in the original accounting framework. Indeed, a number of the countries now following IFRSs do not have fully functioning market-based economies, making the complexity of arriving at supportable fair value estimates even greater.

Countries around the world have operated for decades within their own accounting systems, and cultural differences cause accountants in different countries to interpret and apply accounting standards differently. Such differences can affect the measurement and disclosure of financial information in financial reports and potentially affect cross-border financial statement comparability.

National culture is most likely to influence the application of financial reporting standards where judgment is required. This is of concern due to IFRSs being principles-based and requiring substantial judgment on the part of the accountant and the valuation specialist performing the valuation.

The official working language of the IASB, and the language in which IFRSs are published, is English. Translation of IFRSs into various languages introduces an added complexity in comparability of application of IFRSs across the world, as well as comparability with U.S. GAAP. In some cases, words and phrases used in English-language accounting standards cannot be translated into other languages without some distortion of meaning. For instance, words such as “probable,” “not likely,” “reasonable assurance,” and “remote” can be problematic during interpretation.

In addition, many countries that have moved to IFRSs may have introduced their own country's version of IFRSs; such localization of the standards has led to the creation of many slightly different versions of IFRSs.

Therefore, when analyzing and contrasting financial reporting practices, such as those involving goodwill impairment testing, it is not as simple as a comparison of U.S GAAP and IFRSs.

To highlight the need for greater consistency, the European Securities and Markets Authority (ESMA) issued a Public Statement on November 12, 2012, regarding European common enforcement priorities for 2012 financial statements. ESMA's reason for issuing the statement was “to promote consistent application of the European securities and markets legislation, and more specifically that of [IFRSs]." One of the four “…financial reporting topics which they believe are particularly significant for European listed companies…” [4] was impairment of non-financial assets, including goodwill.

The effects of different accounting treatments

Taking a goodwill impairment can be a necessary, if disappointing, step for a company. For publicly traded companies in particular, depending on how the company has managed market expectations, the move may or may not affect the company’s market pricing. Dealing with inconsistencies from market to market can be even more perplexing. Whatever the situation, companies operating across the global economy continue to face the challenge of differing application of valuation methodologies and accounting principles under U.S. GAAP and IFRSs, local country GAAP, and even country-to-country under IFRSs regarding goodwill impairment testing.

This is a topic of greater significance than just accounting differences. As indicated in its Public Statement, ESMA “would like to stress the need for transparency and the importance of appropriate and consistent application of the recognition, measurement, and disclosure principles provided for in IFRSs in order to ensure the proper functioning of financial markets.”[5]

The next white paper in this Deloitte series will focus in more detail on some of the reasons for differences that can surface in how goodwill impairment is treated under different accounting standards in different countries. In addition, we will look at potential implications of the SEC's final staff report in July 2012 considering the applicability of IFRSs in the financial reporting system for U.S. companies.

About the authors: Greg Forsythe is a Director and the Center of Valuation Excellence Leader for Deloitte Financial Advisory Services LLP. Greg is also the Chair of the Professional Board of the International Valuation Standards Council. Stamos Nicholas is a Principal and the National Business Valuation Leader for Deloitte Financial Advisory Services LLP.

[4] "European common enforcement priorities for 2012 financial statements," European Securities and Markets Authority Public Statement 725, p1, November 12, 2012.
[5] Ibid.