# Discussion Paper

# Goodwill Impairment Testing

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# Discussion Paper: Goodwill Impairment

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# Discussion Paper: Goodwill Impairment Testing

## Introduction

The Accounting Standards Board (AcSB) has issued two new CICA Handbook Sections that are likely to be of particular interest to chartered business valuators (CBVs). As a result, the CICBV struck Task Forces to analyze these new Sections and provide comments regarding these Sections to CICBV members. Issues related to intangible assets will be addressed in a subsequent Discussion Paper.

**The purpose of this Discussion Paper is to raise issues for consideration related to goodwill impairment testing. This Discussion Paper does not necessarily express the view, policies or practice standards of the CICBV or its Members. Readers are responsible for reaching their own conclusions on various issues related to goodwill impairment testing. The CICBV is not responsible for actions taken or not taken or losses or costs arising from reliance on this Discussion Paper or any of the comments contained herein.**

## Purpose and Structure of this Discussion Paper

Recently, the AcSB issued two new CICA Handbook – Accounting Sections:

- Section 3062 – Goodwill and Other Intangibles, and
- Section 1581 – Business Combinations.

The primary focus of this Paper is Section 3062 – Goodwill and Other Intangibles. In applying Section 3062, the separate identification of intangible assets other than goodwill is a factor. An understanding of Section 1581 is required, since Section 1581 addresses the separate identification of intangible assets and liabilities apart from goodwill.

**This Paper has been drafted based on the assumption that the reader has read and is familiar with the following:**

- **CICA Handbook Sections 3062 and 1581**
- **EIC – 124, EIC – 125, EIC – 129, and any subsequent, relevant EICs**

New CICA Handbook Sections 3062 and 1581 are generally similar to accounting standards issued by the U.S.'s Financial Accounting Standards Board (FASB) in the summer of 2001:

- Statement of Financial Accounting Standards (SFAS) No. 141 – Accounting for Business Combinations, and
- Statement of Financial Accounting Standards No. 142 – Accounting for Goodwill and other Intangibles.

The AcSB considers Handbook Sections 3062 and 1581 to be "harmonized" with the US accounting standards in that there are no significant conceptual differences in the standards themselves, though there can be differences in some of the other standards that impact the standards in issue (such as impairment of finite lived assets).

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The purpose of this Paper is to identify and discuss issues of particular importance to Chartered Business Valuators related to the new CICA Handbook Section dealing with goodwill impairment.

This Paper is not intended as a "how to" manual for dealing with the new accounting provisions. Instead, it was developed to:

- provide a level of understanding of the new rules,
- identify issues of importance to business valuators, and
- initiate discussion and further thought as to how to deal with the key issues.

Part I of this Paper contains background information and a general overview of CICA Handbook Sections 3062 and 1581. Part II features a discussion of a number of key issues the Task Force identified related to the new Sections in a question and answer format. This format was chosen to facilitate discussion of the valuation issues related to the new Handbook Sections.

No commentary has been issued by the AcSB related to the valuation issues associated with Sections 3062 and 1581. Because the Handbook Sections are generally similar to the recent U.S. Financial Accounting Standards Board (FASB) standards (as discussed below), when appropriate, the Task Force has drawn on commentary published by numerous U.S. sources, including:

- the American Institute of Certified Public Accountants (AICPA) Practice Aids, in particular, the Practice Aid produced by the AICPA's In Process Research and Development (IPR&D) Task Force,
- FASB staff announcements and concepts statements, and
- the Emerging Issues Task Force (EITF).

We expect that additional issues will arise as companies and their advisors deal with the new Handbook Sections. It is the intention of the Task Force to issue updates to this Paper periodically, as issues arise or as new information and guidance (such as EICs) become available. The most up-to-date version can be found on the CICBVs web site at: **www.businessvaluators.com**

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# Part I: Overview of the CICA Handbook Sections

Before turning to the issues related to the new provisions that are of particular relevance to CBVs, a general overview of the new Sections is in order.

## Section 3062

Section 3062 and SFAS No. 142 deal with the valuation and reporting of goodwill and other intangible assets after their acquisition. The main change in accounting for these assets is that goodwill and other intangible assets with indefinite lives are no longer subject to amortization based on a fixed annual charge. Instead, these assets must be tested annually[1] to determine whether their fair value has been impaired. If, when tested, the fair value is less than the carrying value, the difference must be recorded as an impairment loss expense. Under transitional provisions, however, any impairment in the value of goodwill recognized on the initial application of the new impairment testing rules is recorded as a reduction in retained earnings rather than as an impairment loss expense.

Paragraph 3062.66 states:

> "An impairment loss recognized as a result of the transitional impairment test of either goodwill or intangible assets not subject to amortization is recognized as the effect of a change in accounting policy and charged to opening retained earnings for the fiscal year in which this Section is initially applied, without restatement of prior periods, in accordance with Accounting Changes, Section 1506."

The new accounting rules are complex, as is the required analysis related to goodwill and other intangible assets. While there currently is no requirement for goodwill impairment testing to be completed by business valuation professionals, due to the complexity of the analysis required to comply with the new rules, it is likely that CBVs will increasingly be asked to undertake the analysis or to review calculations completed by management. The CBV's role in impairment testing is addressed in greater detail later in this Paper. Readers should be aware of regulatory issues and the CICA Independence Standards, which are briefly discussed later in this Paper.

## Mechanics of Section 3062

Goodwill is specifically defined for purposes of the Section (Paragraph 3062.05) as:

> "the excess of the cost of an acquired enterprise over the net of the amounts assigned to assets acquired and liabilities assumed. The amount recognized as goodwill includes acquired intangible assets that do not meet the criteria in BUSINESS COMBINATIONS, Section 1581, for recognition as an asset apart from goodwill."

In addition to goodwill, Section 3062 also deals with the valuation and reporting of indefinite lived intangible assets after their acquisition in a business combination.

[1] As discussed later in the Paper, impairment testing is typically completed on an annual basis but in certain circumstances it could be required more or less frequently. For brevity sake, throughout this Paper, impairment testing will be referred to as "annual impairment testing".


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**Implementation**

The provisions of Section 3062 are to be applied to financial statements with fiscal years beginning on or after January 1, 2002. (SFAS No. 142 applies to financial statements with fiscal years beginning on or after December 15, 2001.) Entities other than public enterprises, co-operative ventures, deposit taking institutions, and life insurance entities may defer the adoption of Section 3062 until fiscal years beginning on or after January 1, 2003.

## Section 1581

Section 1581 and SFAS No. 141 eliminated the option of pooling accounting for business combinations and requires all business combinations to be accounted for using the purchase method. They also deal with the purchase price allocation process and the identification of intangible assets and requires that intangible assets be recognized separately from goodwill if either:

i they arise from contractual or other legal rights; or,

ii they are capable of being separated from the entity or transferred by way of sale, lease, rental or license (i.e., they are separable).

## Different methodologies for intangible assets with finite lives vs. indefinite lives

The methodology used to determine if an intangible asset has been impaired and should therefore be written down differs depending on whether the intangible assets have indefinite or finite lives.

Intangible assets with finite lives are addressed in Section 3063 and those with indefinite lives are addressed in Section 3062.

## Annual Testing Requirement

Impairment testing of goodwill should be conducted at the reporting unit level. The determination of what constitutes a reporting unit is complicated and is discussed in more detail in Part II. On a simplified basis, a reporting unit is a portion of the business, segmented at the level at which management reviews and assesses operational performance.

Each of a company's reporting units may adopt a different annual date for impairment testing but once selected, the date must be used consistently.

Goodwill should be tested for impairment annually, unless all of the following criteria are met:

- the assets and liabilities of the reporting unit have not changed significantly from the prior test;
- the most recent determination of fair value exceeded the carrying value of the reporting unit by a substantial amount; and,
- it is considered highly unlikely that the estimated fair value would be less than the carrying value of the reporting unit.

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## Two Stage Testing of Goodwill Impairment

The impairment test is comprised of two stages. The first stage test compares the fair value of the reporting unit to its recorded net book value. If the fair value of the reporting unit's net assets is not less than the recorded book value, no further analysis is required.

If the fair value of the reporting unit's net assets is less than the carrying value of its net assets, goodwill impairment may exist and the second stage of the impairment test must be completed.

The second stage test determines the implied fair value of the reporting unit's goodwill and compares this to its carrying amount. The implied fair value of the reporting unit's goodwill is determined by deducting the fair value of the assets (less liabilities) from the fair value of the reporting unit as if it had been acquired in a business combination. The reporting unit's goodwill[2] is equal to the balance or residual so calculated. If the fair value of the goodwill is less than its carrying value, an impairment loss equal to the difference is recognized. Once goodwill has been written down for impairment, no future recovery of goodwill may be recorded. If the fair value of goodwill is greater than the carrying value, however, a write up of goodwill is not permitted.

[2] In accordance with CICA Handbook Section 1581, fair value is allocated to all of the assets of the reporting unit, including identifiable intangible assets, with the remainder allocated to goodwill. As discussed below, for purposes of goodwill impairment testing, fair value should be allocated to a reporting unit's intangible assets even if they are not recorded in the entity's financial statements.

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# Part II: Questions and Answers

## 1. What range of services can a CBV provide clients and what limitations apply?

The services CBVs could provide regarding goodwill impairment testing are wide ranging and could include:

- discussing and educating clients on the requirements of the new accounting rules, related concepts, terminology and implementation issues;
- providing guidance to assist management and their external accountants in the determination of their reporting units;
- providing guidance in the development of the client's reporting unit valuation model(s);
- discussing documentation requirements related to goodwill impairment and intangible asset impairment testing;
- performing market and industry research on behalf of clients to support valuation assumptions;
- assisting clients in the determination of appropriate discount and capitalization rates;
- assisting management in establishing effective data collection processes to aid in regular evaluation of impairment testing;
- reviewing third party valuation analysis, including valuation assumptions and calculations; and
- performing Section 5049 reviews for auditors (FSAS No. 73).

There are certain limitations to the above noted services. Where the client is also an audit client of the valuator's firm, the types of services offered by a valuator will be subject to the independence rules of applicable institutes such as the Provincial Institutes, the CICA, the AICPA and regulatory bodies such as the Ontario Securities Commission and the U.S. Securities Exchange Commission. A CBV must also abide by the CICBV Code of Ethics.

## 2. Is the definition of fair value contained in Section 3062 consistent with the generally accepted definition of fair market value?

Paragraph 3062.05 defines fair value as:

> "the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act."

The definition of fair market value typically adopted by business valuators is: the highest price available in an open and unrestricted market, between informed and prudent parties acting at arm's length and under no compulsion to act, expressed in terms of money or money's worth.

Fair value for purposes of Section 3062 is generally assumed to be equivalent to the definition of fair market value typically adopted by business valuators. However, there are some areas of possible difference that valuators should be aware of. For example, the Section 3062 definition of fair value does not specifically address the concepts of highest price or an open and unrestricted purchaser market. These differences are explored below.

**Highest price** – The Section 3062 definition does not specify that fair value is equal to the highest price available. While it would not be reasonable to assume that any price could be used to satisfy the Section 3062 definition of fair value, the highest price may not necessarily be appropriate in every case. Because Section 3062 does not provide guidance in this area, it is useful to turn to other sources and commentary for guidance.

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The AICPA has published a Practice Aid[3] that addresses fair value. While the Practice Aid deals specifically with in-process research and development, the comments made regarding fair value are relevant. The AICPA Practice Aid states that fair value should reflect the hypothetical market price based on the assumptions market participants would use in arriving at an estimate of value. This estimate of value by market participants might not be the highest possible price, since the specific synergistic benefits and strategic advantage should not be included if they are specific to a single purchaser. The appropriateness of including purchaser-specific synergistic benefits and strategic advantage is discussed in more detail below.

**Open and unrestricted market** – Section 3062 does not specify that in determining fair value the valuator should include all purchasers consistent with the open and unrestricted market concept contained in the definition of fair market value. Again, it is possible to gain insight into this issue from a review of the AICPA Practice Aid.

The AICPA Practice Aid takes the position that the market of potential purchasers should include all potential purchasers whether or not the potential buyers are engaged in discussions with the seller of the business. The AICPA Practice Aid also states that the valuator should consider only those potential buyers that appear to have the ability to acquire the assets being valued.

Subject to the discussion below regarding the inclusion of synergistic benefits and strategic advantage, given the similarity between Section 3062 and FSAS No. 142 and the guidance provided by the AICPA, it is reasonable to conclude that fair value as defined in Section 3062 is consistent with the generally accepted definition of fair market value.

## 3. Does the Section 3062 definition of fair value include consideration of synergistic benefits and strategic advantage?

Section 3062 does not provide guidance with respect to consideration of synergistic benefits and strategic advantage. Guidance in the AICPA Practice Aid indicates that in estimating fair value of the assets, valuation specialists would not take into consideration any company specific benefits or cost savings acquired because investment value and buyer specific value do not conform to the concept of fair value, as that term is defined by generally accepted accounting principles. Furthermore, according to the AICPA Practice Aid, if the acquiring company pays any significant consideration for synergistic or strategic benefits in excess of those expected to be realized by market participants, the valuation specialist would identify those excess benefits and remove them from the valuation of the acquired assets. Under this approach, the assumptions to be used in making estimates of fair value would reflect the best estimate of how market participants would benefit from use of the asset being acquired and it therefore appears that fair value is to be determined with reference to the market as a whole, rather than reflecting the specific characteristics of a single purchaser.

Applying the rationale provided in the AICPA literature, it may be reasonable to conclude that fair value as defined in Section 3062 would not include synergistic benefits or strategic advantages that were only available to a specific acquirer. Instead, the price should reflect the hypothetical market price based on the assumptions market participants would use in their estimates of value. To the extent the hypothetical market includes strategic purchasers, fair value as defined in Section 3062 as it applies to reporting units would include synergistic benefits and strategic advantages to some degree but would not necessarily include such benefits and advantages specific to a particular purchaser.

[3] AICPA Practice Aid Series: *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries* (prepared by the AICPA IPR&D Task Force).

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The AICPA Practice Aid states that the fair value of intangible assets should be determined on an asset-by-asset basis, and would be the hypothetical market price for each asset on a piecemeal basis as if each asset were traded on an established market. If the fair value of individual assets is determined on a piecemeal basis, any benefit related to the combination of the individual assets in the subject business would be included in goodwill. Similarly, any strategic advantage or synergistic benefit would also be included in goodwill.

## 4. Is the Section 3062 definition of fair value consistent with the concept of value in use and value to owner?

From the perspective of a business valuator, value in use contemplates the fair market value of a particular asset as part of the business as a whole.[4] For example, the value in use of a fixed asset would include costs related to items such as installation and testing. The value in use concept typically adopted by business valuators is consistent with fair value pursuant to Section 3062. However, value in use from a GAAP perspective relates to the concept of an owner specific use for particular assets. Value in use from a GAAP perspective is similar to the value to owner concept used by business valuators.

Section 3062 defines fair value as the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. An AICPA Task Force examined assets acquired in a business combination and concluded that the concept of fair value in accounting literature does not have an equal in the appraisal literature. The AICPA stated that:

> "Historically, valuation specialists may have used premises/standards of value in assigning cost to assets acquired in a business combination that include "liquidation," "in-exchange," "in-use," or "investment" value. These premises/standards of value should be neither used nor referred to in valuation reports that will be used in assigning cost to assets acquired in a business combination pursuant to FASB Statement No. 141[CICA 3062]; these premises/standards of value would not be appropriate because GAAP requires the use of fair value." [5]

It appears that the concept of value to owner is not intended to be used in the determination of fair value for purposes of Section 3062. Value to owner in excess of an amount that could be realized on an arm's length sale is not included in the determination of fair value for purposes of Section 3062. A Section 3062 fair value is based on a hypothetical market purchaser that does not have any specific characteristics that would allow it to benefit from the use of this asset differently than other market purchasers. That is consistent with valuation theory, which states that a special purchaser would only pay one dollar more than other market participants to acquire an asset.

Section 1581, which relates to the allocation of purchase price as a result of a transaction appears to be inconsistent with respect to value to owner. Paragraph 1581.42 wording appears to allow for the inclusion of value to owner:

> "the fair value at the date of the acquisition is the fair value to the acquirer, recognizing all factors that may be relevant to that acquirer".

[4] It should be noted that accountants define "value in use" as the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its life. The cash flow projections are based on management's best estimates and are entity-specific. This differs from fair value, which uses market based assumptions.

[5] AICPA Practice Aid Series: *Assets Acquired in a Business Combination to be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries,* p. 4.

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Section 1581, Appendix A appears to exclude value to owner. Paragraph A11 states:

> "An enterprise's best estimate of the present value of cash flows will not necessarily equal the fair value of those uncertain cash flows. There are several reasons why an enterprise might expect to realize or pay cash flows different from those expected by others in the market place."

As previously discussed, with respect to synergistic value, the hypothetical price based on assumptions by the market would tend to lead to an exclusion of value to owner.

Value derived from the specific use of an asset intended by an owner would not be included in fair value if that value could not be realized by a hypothetical market acquirer.

## 5. What guidelines should valuators follow to determine appropriate fair value assumptions when assigning fair value to assets and liabilities?

GAAP uses a hierarchy of evidence to determine fair value. Quoted market prices in an active market are the best evidence of fair value, if available. Unfortunately quoted market pricing does not exist for most individual assets. Because fair value reflects an amount at which an asset (or liability) could be bought (or assumed) or sold (or settled) in a current transaction between willing parties, an accounting estimate of fair value should incorporate assumptions that marketplace participants would use in developing their estimates of fair value.

Section 1581, Appendix A, Paragraph A5 indicates that judgment is required in selecting the most appropriate valuation methodology to apply and that valuation techniques used would be consistent with the objective of measuring fair value. As noted above, though quoted market prices in active markets are the best evidence of fair value when available, Appendix A, Paragraph A5 makes it clear that when quoted market prices are not available or are not representative of fair value, estimates of fair value should be based on the best information available, including comparable prices and the results of other valuation techniques. Appendix A addresses valuation techniques based on multiples of earnings and revenue. Appendix A, Paragraph A8 also states that a present value technique is often the best available technique for estimating the fair value of a group of items (such as a group of assets in a reporting unit).

So what assumptions are appropriate to determine fair value for GAAP purposes? The AICPA task force concluded that the fair value of an acquired asset, including an intangible asset, for financial reporting purposes is the amount at which that asset would be bought and sold on a piecemeal basis in a current transaction between the seller and a hypothetical market place buyer, i.e., a market participant, in other than a forced or liquidation sale[6]. For purposes of assigning cost to the assets acquired, the amount of the purchase price allocated to an acquired intangible asset would not be based on that intangible asset's contribution to the enterprise and going concern value or synergistic value. The hypothetical market price would incorporate assumptions that market participants would use in their estimates of value. As a result, fair value does not include strategic or synergistic value resulting from expectations about future events that are specific to a particular buyer because the value associated with those components is unique to the buyer and seller and would not reflect market-based assumptions. Entity-specific value associated with strategic or a synergistic component would be included in goodwill.

Consistent with the market concept, fair value would exclude the influence on market prices of potential purchasers who would be excluded from acquiring a particular asset. In addition, where market purchasers would view assets on a combined basis, the assets should be similarly grouped for fair value determination pursuant to Section 1581.

[6] AICPA Practice Aid Series: *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries,* pp. 6-7.

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## 6. In determining the fair value of components of reporting units and/or individual intangible assets, when should a valuator consider the use of a specialist? What criteria should be considered when selecting a specialist?

In determining the fair value of business units and/or intangible assets, a valuator may encounter situations where aspects of particular assets or industries fall outside the scope of his/her knowledge. For example, specialized industries such as resource or technology based industries may require the use of industry experts, lawyers, engineers, etc. These individuals may help provide inputs into the feasibility and market of certain intangible assets and/or provide direct input into the valuation approach adopted by the valuator.

Types of specialists a valuator may use in determining the fair value of a reporting unit or intangible asset include:

- industry, functional, and asset-specific experts – for input into market feasibility and acceptance of products, as well as input on the technical and economic life of specific tangible and intangible assets;
- reserve engineers – for estimating quantities and values of oil and gas reserves;
- environmental experts – for determining environmental liabilities and contingent liabilities, as well as site clean-up costs, etc.;
- lawyers – for determining whether the rights, title and interest in assets legally exist and who holds rights to those assets (e.g., in determining separability of the asset);
- information technology experts – for complex aspects of information system assets, such as software, microprocessors, etc.

In these situations, the business valuator should consider the guidance provided by:

- the CICBV Code of Ethics;
- CICA Handbook Section 5049 – Use of Specialists in Assurance Based Engagements; and
- Statement of Auditing Standards (SAS) 73.

## 7. Are the implementation guidelines of Section 1581 Appendix A consistent with generally accepted valuation methodology?

Appendix A, Paragraph A2 of Section 1581 states:

> "Quoted market prices in active markets, if available, are the best evidence of fair value and are, therefore, used as the basis for fair value measurement, when available."

Appendix A does not specifically address the issue of whether public market prices represent minority interests and therefore whether the market capitalization derived from current trading prices should be adjusted to reflect the elimination of the implied minority discount. However, Appendix A does raise for consideration other issues associated with public market prices, stating in Paragraph A8 that other factors, if identifiable, should be taken into account, including illiquidity and market imperfections.

Appendix A, Paragraph A3 addresses business combinations effected by issuing shares and states:

> "…The value of the shares is based on their market price over a reasonable period before and after the date the terms of the business combination are agreed to and announced."

Similar wording is included in EIC – 125

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Generally accepted valuation principles exclude the use of hindsight in fair market value determinations (there are exceptions to this rule, such as using information subsequent to the valuation date to test the reasonableness of assumptions). The use of trading prices subsequent to the valuation date would be viewed as hindsight and therefore would not be considered in a business valuator's normal fair market value determinations.

With the exception of the suggested use of public market trading prices subsequent to the valuation date, the methodologies included in Section 1581 Appendix A are generally consistent with methodologies typically adopted by business valuators.

The business valuator should ensure that the assumptions adopted in the goodwill impairment testing are communicated to accounting professionals that will rely on the business valuators work.

## 8. Are the guidelines provided in Section 1581 consistent with general valuation methodology with respect to future income taxes?

The inclusion of future tax assets and liabilities without discounting as specified in Section 1581 is not consistent with general valuation methodology. The allocation of the fair value of a reporting unit to its assets and liabilities should be completed as prescribed in section 1581 (consistent with the methodology applied in a purchase price allocation). Paragraph 1581.47 states:

> "…Future income tax assets and liabilities included in the allocation of the cost of the purchase are measured in accordance with the requirements of Section 3645 and therefore are not discounted."

Typically, business valuators would determine the fair market value of future income tax liabilities or assets based on the expected timing of the cash inflow or outflow discounted to present value at a rate of return that reflects the risk of the tax inflow or outflow occurring at the time and in the quantum estimated. Thus, for future tax assets, Paragraph 1581.47 is not consistent with generally applied methodology used to determine fair market value. From a fair market value perspective the application of 1581.47 (the allocation of fair value to tax assets or liabilities on an undiscounted basis) will a result in an over allocation to future tax assets and an equal understatement in goodwill. For future tax liabilities, application of Paragraph 1581.47 will result in an over allocation to the tax liability and a corresponding overstatement of goodwill.

Section 1581 specifies that the fair value of individual assets to which the fair value of the reporting unit is allocated should be determined on an individual asset basis. That is, the fair value of the individual assets should reflect the amount a purchaser would pay for that particular asset. Using generally applied valuation methodology, the fair value of an asset acquired pursuant to an asset transaction would include the benefit related to the purchaser's ability to write off the capital cost of the asset for tax purposes. The fair value of the future benefit would be determined by discounting to present value the future tax savings typically through the use of a tax shield formula.

However, the fair value of goodwill as determined should not be "grossed up" to reflect the benefit of the related tax shelter from an assumed asset transaction. The fair value of goodwill is determined by subtracting from the fair value of the reporting unit the fair value of all identified assets and liabilities (a residual value approach). The residual amount so determined represents the total fair value of goodwill inclusive of any tax savings related to the future write off of eligible capital amount. No incremental amount should be added to reflect the present value of the future tax savings.

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## 9. What procedures should be followed to identify tangible and intangible assets in a reporting unit?

At the outset of the valuation analysis, the valuator and management should identify all assets acquired that are subject to valuation procedures.[7] Many assets will be identifiable from the balance sheet of the acquired company based on historical transactions e.g., working capital items, tangible and intangible assets resulting from prior business combinations or asset acquisitions. Historical balance sheets, however, do not include intangible assets that were developed internally by the acquired company. In addition, historical balance sheets may report goodwill and intangible assets on a combined basis. Further, while operating results may be available for reporting units, in many cases complete balance sheet information may not be available.

Section 1581 provides criteria for identifying intangible assets that should be identified separately for goodwill.

During the analysis of historical financial data, the valuator should interview management of the acquiring and acquired companies, including those responsible for marketing and technology development. During these interviews the valuator should collect company data relating to product offerings, channels of distribution, facilities, operations of the acquired company, and research and development efforts underway by the acquired company. The purpose of those interviews is to ascertain the existence of other intangible assets not readily apparent from a review of the available historical financial data. In conducting interviews of management, the valuator generally will make reference to a list of potential intangible assets, such as those specified in Appendix A to Section 1581. Perhaps the most meaningful question for a valuator to ask management is, "What is your perception of the assets included in the reporting unit?"

The valuator also should review the following information in evaluating management's identification and classification of intangible assets acquired by the entity:

- presentations to the board of directors,
- offering memoranda,
- legal documentation related to the business combination,
- tax filings related to the acquisition,
- due diligence reports,
- press releases (including those of the acquired company before the business combination),
- web site materials,
- analysts reports, and
- industry reports.

Ultimately, the valuator must agree with management on a specified listing of assets to be valued, based on the facts and circumstances of the reporting unit's operations and the experience of management and the valuator.

[7] AICPA Practice Aid Series: *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*, pg. 76.

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## 10. Who has the responsibility for defining each reporting unit?

Management is responsible for the determination of a company's reporting units and needs to define reporting units in accordance with GAAP., Auditors and accountants will need to ensure that GAAP is followed. In arriving at fair value, the business valuator should understand the basis for management's determination of reporting units.

Though the determination of what constitutes a reporting unit lies with management and the accounting/audit expert, a valuator may offer some assistance and guidance with particular reference to the characteristics described in the bulleted list above. Such assistance may include determining the following:

- whether a component constitutes a business, or
- whether two components have similar economic characteristics.

In determining whether a component constitutes a business, guidance can be in found EIC – 124.

The phrase "similar economic characteristics" is not defined in the CICA Handbook. EIC – 129 lists factors to be considered.

As outside professionals, business valuators may be asked to provide advice in determining reporting units and whether they have similar economic characteristics but it remains management's responsibility to define reporting units.

## 11. What are the criteria for establishing a "reporting unit"?

Paragraph 3062.36 states:

> "For the purpose of testing goodwill for impairment, all goodwill acquired in a business combination should be assigned to one or more reporting units as of the date of acquisition."

Paragraph 3062.05(d) defines a reporting unit as:

> "…the level of reporting at which goodwill is tested for impairment and is either an operating segment (see SEGMENT DISCLOSURES, Section 1701), or one level below (referred to as a component). A component of an operating segment is a reporting unit when the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component. (Segment management consists of one or more segment managers, as that term is defined in SEGMENT DISCLOSURES, Section 1701.) However, two or more components of an operating segment are aggregated and deemed a single reporting unit when the components have similar economic characteristics. An operating segment is deemed to be a reporting unit when all of its components are similar, when none of its components is a reporting unit, or when it is comprised of only a single component."

Though Section 3062 describes a number of characteristics that should be present for a component of an operating segment to be considered a reporting unit, no single factor or characteristic is determinative. How an entity manages its operations and how an acquired entity is integrated with the acquiring entity are key to determining the reporting units of the entity. A reporting unit is a segment of the business that reflects the way an entity manages its business or operations and to which goodwill naturally is associated. The financial and operational information an entity reports for internal management purposes will provide assistance in determining reporting units.

EIC – 129 expands on the discussion of reporting units.

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## 12. When considering whether a business has been acquired in a business combination, what is a business?

It is important to consider whether a business has been acquired in a business combination. By definition, if a business has not been acquired, there cannot be any goodwill.

CICA Handbook Sections 1581 and 3062, and their U.S. counterparts, relate to the transfer or purchase of a business and not to the transfer or purchase of a group of assets or of a single asset. The definition of what constitutes a business was addressed in some detail in the EIC 124, where a business was defined as:

> "a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. A business consists of
> (a) inputs;
> (b) processes applied to those inputs; and
> (c) outputs that are used to generate revenue."

EIC – 124 also provides guidance regarding what may or may not constitute a business. For example, if a set of activities or assets exclude one or more of items (a) to (c) above, such that the set of activities or assets are not able to continue normal operations and sustain a revenue stream, the set of activities or assets are not considered a "business". Another example of when no business exists is when there is a single tangible or intangible asset that represents all but a small part of the fair market value of a set of activities or assets being transferred. As well, the purchase of a single product, such as rights to a consumer product, is likely not considered a "business". On the other hand, the purchase of a factory with related inputs, processes and outputs is likely to meet the definition of a "business". EIC – 124 provides other examples of the application of the definition of a business.

## 13. What are the practical and appropriate methods for allocating assets and assigning goodwill to a company's reporting units?

In many instances there will not be a GAAP balance sheet for reporting units. In such cases, the methodology used to allocate assets and assign goodwill to more than one reporting unit needs to be reasonable, supportable, and applied in a consistent manner. Goodwill should be assigned to the reporting units that are expected to benefit from the synergies of the combination even though other assets or liabilities of the acquired company may not be assigned to those reporting units. For goodwill that is related to the entity as a whole, that portion of goodwill should be assigned to all of the reporting units of the entity in a reasonable and supportable fashion. For purposes of impairment testing, all goodwill needs to be assigned to the reporting units.

Goodwill cannot be reassigned or moved to other reporting units unless there has been a reorganization of the enterprise's operations or reporting structure. If there is a reorganization, valuators should look for guidance to Paragraph 3061.38.

There is no need to allocate out all assets to reporting units. But, assets allocated must be consistent with the cash flows associated with the reporting unit. Where a reporting unit employs unallocated corporate assets, a contributory charge for the use of those assets should be reflected in the reporting unit's cash flow.

For acquisitions after June 30, 2001, the purchase price is to be allocated in accordance with Section 1581, which provides that the difference between the purchase price and the fair value of the net assets acquired (tangible and intangible) is to be allocated to the goodwill of one or more reporting units.

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According to Paragraph 1581.65, for acquisitions made prior to July 1, 2001, a portion of the carrying value of goodwill may have to be allocated to identifiable intangible assets of one or more reporting units and the remaining goodwill allocated to one or more reporting units.

Trade receivables, inventory, equipment, payables, etc., should be easily identified. In most situations the allocation of these assets and liabilities to reporting units is relatively straightforward.

“Corporate” assets and liabilities and “shared” assets and liabilities are allocated to reporting units if the asset is employed in, or the liability relates, to the operations of the reporting unit, and the asset or liability is considered in the fair value. Such allocations must be done in a reasonable, supportable and consistent manner. Depending on the nature of the asset, the following allocation bases may be appropriate:

- relative revenues,
- units of production/hours in use,
- use of employees,
- square footage,
- relative working capital requirements, and
- relative fair value.

## 14. If a reporting unit is unaudited, can the valuator rely on internal financial statements?

Valuators must allocate fair value among the reporting unit’s assets and liabilities and therefore need to understand the assets and liabilities included by management in each reporting unit. The valuator should be comfortable that the methodology used to determine carrying value was reasonable, supportable and applied in a consistent manner with prior years and with other reporting units.

Each reporting unit is supposed to have discrete financial information, though such information is likely to be unaudited. In many situations companies will not have initially compiled all of the financial information required for goodwill impairment testing. Consistent with the basis by which reporting units are defined, companies will track operating results for reporting units, but balance sheet information may not be available. (In the case of public companies, there is a good chance such information would be developed.) It may be possible to adjust systems that currently compile information for segmented reporting to provide financial information on more a operationally detailed, lower reporting unit level. It should be remembered that financial information of lower reporting units must be consistent and reconcilable with financial information for segmented reporting. It is not feasible to require audited information for each reporting unit. However, the financial information should be reviewed for reasonableness and any variances should be disclosed. Where significant variances are present, a disclaimer may be appropriate.

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## 15. Should forecast information prepared for Goodwill impairment testing match that prepared for other purposes?

Information used for goodwill impairment testing should be based on information prepared for management purpose. Information for goodwill impairment testing should be based on expectation of market participants, consistent with the definition of fair value. Forecasts prepared by management for internal purposes may differ from forecasts that are appropriate for fair value purposes. Valuators should understand differences between management's forecast for operating purposes and forecasts for fair value determinations. The valuator should perform typical due diligence procedures for reviewing forecasts, commensurate with the type of report the valuator is providing.

Forecast assumptions should be reasonable and consistent. Regulators indicate they will challenge inconsistent cash flow estimates and related assumptions used in estimating fair value. The following types of questions should be considered when reviewing the assumptions used in a valuation analysis that employs a present value technique[8]:

- Has the uncertainty associated with the amount and timing of cash flows been reflected in the estimated future cash flows or in the interest rate (i.e., discount rate), but not both?
- If the underlying assumptions are based on the entity's intended use of an asset or settlement of a liability, is there any information available to suggest that marketplace participants would use different assumptions? If so, the marketplace participant assumptions should be used.
- Are the revenue and expense assumptions consistent with historical performance and industry outlook?
- Are all reasonable expenses included in the analysis unless there is a reasonable, documented explanation for their exclusion?
- If historical profit margins are used as a guide for determining whether all reasonable expenses are included, have other factors been considered that may cause historical measures to be inappropriate (e.g., new competition)?
- Is the discount rate used consistent with the nature of the forecast and is it appropriate, given the reporting unit's (or asset's) particular facts and circumstances?
- If an industry weighted average cost of capital was considered in selecting the appropriate discount rate, is it appropriate for the particular reporting unit?
- Is the terminal growth rate reasonable, relative to historical trends and industry forecasts?

Additional guidance regarding procedures a valuator may undertake with respect to forecast information can be found in AICPA Practice Aid Series: *Assets Acquired in a Business Combination to be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*, pp. 72-72, paragraphs 5.3.12—5.3.16.

[8] Financial Reporting Developments – Accounting for Business Combinations, Goodwill and Intangible Asset s- FASB Statements 141 and 142, Ernst & Young, December 2001 First Edition.

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## 16. Should a reconciliation or comparison be done between the goodwill impairment test and any prior valuation reports?

It is important to understand that valuation reports and goodwill impairment tests are performed under different mandates and scopes. Goodwill impairment tests are performed for specific accounting purposes, whereas valuation reports typically are performed for non-accounting related matters.

The relevance of a comparison between the valuation reports and the goodwill impairment tests depends on the time lag between the valuation report date and the annual impairment test date. The longer time between the two, the less relevant the valuation comparison. Where prior valuations are more recent, there may be merit in comparing and understanding the reasons for any significant variation in value. Typically, in practice, when performing a valuation, a comparison is done with any recent prior valuation reports, though there is no requirement to do so.

## 17. What is the definition of an acquired intangible asset and when are intangible assets recognized apart from goodwill?

Intangible assets are defined in Section 1581 as current and non-current assets (not including financial instruments) that lack physical substance. According to Paragraph 1581.48:

> "An intangible asset should be recognized apart from goodwill when:
> (a) the asset results from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired enterprise or from other rights and obligations); or
> (b) the asset is capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so).
> Otherwise it should be included in the amount recognized as goodwill."

An intangible asset that is not separable individually will still meet the separability criterion if it can be separated or divided from the company and sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset, or liability. An example of such an intangible asset is depositor relationship intangible assets because they relate to deposit liabilities. The depositor relationship intangible asset should be recognized apart from goodwill.

It is noteworthy that the Ontario Securities Commission's Corporate Finance Branch recently indicated in OSC Staff Notice 51-708:

> "[they] have encountered situations where intangible assets that meet the criteria for recognition apart from goodwill appear to have been acquired in a business combination, but have not been accounted for in accordance with the standard. [They] will aggressively pursue such deficiencies in financial statements."

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Appendix A to Section1581 includes examples of intangible assets for five broad categories that normally meet the criteria for recognition apart from goodwill and provides guidelines in applying the recognition criteria. The five broad categories of intangible asset are:

1. marketing-related intangible assets
2. customer-related intangible assets
3. artistic-related intangible assets
4. contract-based intangible assets
5. technology-based intangible assets

Discussion of intangible assets and appropriate valuation methodology will be addressed in a separate Discussion Paper.

## 18. Are publicly traded prices indicative of fair value for goodwill impairment testing?

**Determining the Fair Value of Reporting Units**

The fair value of a reporting unit is the amount at which the unit as a whole could be bought or sold in a current transaction between willing parties (i.e., other than in a forced or liquidation sale). If a public company has only one reporting unit, then the market capitalization of the public company provides certain evidence about the fair value of that reporting unit. However, the market price of a single share of common stock and the associated market capitalization of a reporting unit with publicly traded equity securities may not be representative of the fair value of the reporting unit as a whole. Quoted market prices generally represent trading in minority lots and therefore, the quoted market price of individual securities should not be the sole measurement basis of the fair value of a reporting unit without consideration of the market of minority issues.

When the quoted market price of shares of a reporting unit is available, and those shares are thinly traded or the share price is volatile, the company may consider the quoted market prices to be unreliable and seek other sources of fair value information. Value-relevant information from recent transactions may also be useful in determining fair value of a reporting unit.

Estimates of fair value should be based on the best information available, including values of similar businesses and the results of using other valuation techniques. A present value technique is often the best method available to estimate the fair value of a business, such as a reporting unit. However, valuation techniques other than a present value technique are not precluded, provided the resulting measurement is consistent with the objective of measuring fair value.

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## 19. When performing step one of the goodwill impairment test, should the determination of fair value of a reporting unit assume a share or asset transaction?

The determination of the fair value of a reporting unit may be materially affected by the assumed transaction structure. If, for example, a valuator adopts an income or cash flow based approach to determine the fair value of a business unit, the assumed level of future income/cash flow may be different under an assumed taxable transaction as compared to a non-taxable transaction. For instance, under an assumed asset sale, a potential purchaser may be able to shelter future income taxes incurred by the business unit through the deduction of capital cost allowance on a "stepped-up" cost base of the underlying assets. In a situation where a potential purchaser would receive a step up in the cost base of the asset, that purchaser would be willing to pay more for those assets vis-à-vis a share purchase. Accordingly, whether the fair value of a business unit or intangible asset is determined using an asset or share sale may result in that unit or asset passing or failing the impairment test.

There are at least three possible alternatives available in the determination of fair value:

1. Assume a transaction would occur based on a taxable transaction (an asset sale), in which case the determination of fair value would include the value of the potential tax benefit resulting from the CCA available to a purchaser of assets at a "stepped-up" cost base.

2. The determination of fair value should be based on the transaction structure that originally gave rise to the goodwill of the business unit.

3. The determination of fair value should be based on the most likely structure that would arise in an actual transaction (i.e., assets or shares).

According to a recent Emerging Issues Task Force Discussion Issue No. 02-13, the EITF reached a consensus that whether fair value should be determined pursuant to a taxable or non-taxable transaction is a matter of judgment that depends on the relevant facts and circumstances and must be evaluated on a case-by-case basis. The EITF discussion stated that:

> "in making that determination, an entity should consider (a) whether the assumption is consistent with those that marketplace participants would incorporate into their estimates of fair value, (b) the feasibility of the assumed structure, and (c) whether the assumed structure results in the consideration of related tax implications."

Though a valuator may provide input into the assumed structure, the issue needs to be discussed and resolved with the accounting/auditing experts regarding the interpretation of Section 3062.

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## 20. In performing step one of the goodwill impairment test, should future income taxes be included in the carrying amount and fair value of a reporting unit?

The carrying value of the reporting unit and its fair value calculation, if future taxes are considered in the carrying value, then they must be considered in the fair value calculations. The valuator requires an understanding of how items are treated for reporting unit valuation purposes so that those items are treated consistently in assigning assets and liabilities to the reporting unit. It is important to assign all assets and liabilities necessary to operate as a business to the reporting unit, for example, pension liabilities related to active employees should be included in determining the fair value of the reporting unit. The valuator must understand the various components that are included in future taxes to determine which reporting unit they should be allocated to, if approproate.

According to Paragraph 3062.33:

> "For the purposes of testing goodwill for impairment, acquired assets and assumed liabilities should be assigned to a reporting unit as of the date of acquisition, when:
> a) the asset is employed in, or the liability relates to, the operations of a reporting unit; and
> b) the asset or liability is considered in determining the fair value of the reporting unit."

The treatment of future income taxes for the purposes of the goodwill impairment test should be discussed with accounting/audit experts in each situation. While components of future income taxes may relate to assets employed in, or liabilities relating to, the operations of a reporting unit, the future taxes may not be transferred from a seller to a buyer in an assumed asset transaction structure. The valuator can provide input into ensuring that the treatment of future income taxes is consistent with the assumed transaction structure used for determining the fair value of the business unit.

In the EITF Discussion Issue No. 02-13, the EITF reached a consensus that an entity should use the income tax bases of a reporting unit's assets and liabilities implicit in the tax structure assumed in its estimation of fair value of the reporting unit in step one. That is, if the assumed structure was a non-taxable transaction, an entity should use its existing income tax base, while under an assumed taxable transaction, an entity should use new income tax bases.

## 21. In performing step two of the goodwill impairment test, should the fair value of assets and liabilities be determined using the existing tax cost base or assuming the new cost base for the assets and liabilities?

Once again, a valuator should consult with the accounting/audit expert to determine the appropriate interpretation of Section 3062 and then ensure that the determination of fair value is consistent with the assumed structure. For example, if the fair value of the business unit is determined assuming an asset sale, a new tax cost base is established and therefore the existing tax attributes of the assets would not be considered relevant.

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## 22. Why do we perform a two step goodwill impairment test?

To test for goodwill impairment, a two step process was developed. The U.S. Financial Accounting Standards Board (FASB) considered a number of methods to evaluate goodwill impairment (see FASB 142 Appendix B123-135). FASB concluded that subtracting the fair value of both recognized and unrecognized net assets would result in an estimate closest to the implied fair value of goodwill. In Appendix B135 of FSAS No. 142, FASB noted:

> "… that [the purchase price allocation] method is the same method by which goodwill is initially measured, the resulting reported amount of goodwill (after the impairment charge) would be the best available estimate consistent with the initial measurement of goodwill upon its acquisition."

Initially, FASB rejected the purchase price allocation approach because it considered the process of identifying unrecognized net assets and determining their fair values to be too costly to be required on a frequent basis. FASB subsequently decided that if the measurement of goodwill impairment was preceded by a less costly screen that would evaluate potential impairment, the cost of measuring goodwill using a purchase price allocation process was justified. As a result, FASB developed a two step process: step one being the initial test of goodwill impairment, and if this screen fails, a step two test would calculate the implied fair value of goodwill. The step two test would consider all the assets and liabilities associated with the reporting unit, including unrecognized intangible assets.

In considering Section 3062, Canadian accounting standard setters evaluated FASB's conclusions and agreed that their approach to evaluate and estimate goodwill impairment were appropriate for Canadian GAAP purposes.

## 23. Can there be an immediate impairment in the value of the acquired intangible assets and of goodwill?

It is possible for there to be an immediate impairment in the acquired intangible assets and/or goodwill where the announcement date differs from the closing date of a transaction and the impairment testing date. This could occur, for example, when there are rapid market, industry, economic or technological changes. Consider this example: assume on January 10, 2002 Company A announced its acquisition of Company B, which has developed a revolutionary new technology (Company B's only asset) that is expected to be launched in the market over the next few months. The transaction closed on February 28, 2002. In the interim, Company C launched a technology that is better than Company B's, rendering Company B's obsolete. The changes in events between announcement date and closing date may be consideredo have triggered an immediate impairment in the acquired intangible and/or goodwill value of Company B.[9]

[9] The example has been simplified for illustrative purposes only and the factors associated with determining the impairment of an acquired intangible and/or goodwill have not been considered.

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## 24. Does the goodwill impairment test qualify as a prior valuation report under OSC Rule 61-501?

For the purpose of Ontario Securities Commission Rule 61-501, which is concerned with related party transactions, a “prior valuation” is basically a valuation or appraisal of an issuer or its securities or material assets, whether or not prepared by an independent valuator, that, if disclosed, would reasonably be expected to affect the decision of a beneficial owner to vote for or against a transaction or to retain or dispose of affected securities.

Reporting units may not be comparable to specific assets or securities to be valued under OSC Rule 61-501. Goodwill impairment tests are conducted on the individual reporting units. Depending on the size or comparability of assets/securities, the OSC’s definition of a “prior valuation” under Rule 61-501 may be applicable.

While there are no established rules or precedents, clients may want to seek legal advice when considering this issue.

## 25. What level of reporting/comfort can the valuator provide?

The valuator will normally be called upon to provide an opinion with respect to the fair value of a reporting unit and/or the goodwill of a reporting unit. Before commencing the engagement, the valuator should review the scope and reporting requirements of the engagement with management, the auditors and perhaps members of the Board or Audit Committee, to ensure the objectives of all parties will be addressed.

Given that financial reporting for a reporting unit may be minimal, the valuator should be particularly aware of, and disclose, any reporting limitations or qualifications, based on the CICBV's professional standards and consideration of the issues raised in this discussion paper.

## 26. What practice issues should a valuator keep in mind when considering these new CICA Handbook Sections?

The following are a few specific issues a valuator should keep in mind:

- Ensure the roles of the accounting expert and valuator are clearly defined at the outset – there may be many areas of perceived overlap.
- Be sure to follow CICBV reporting and work standards for independent opinions/estimates.
- Be familiar with both Canadian and U.S. pronouncements and interpretations related to the goodwill impairment rules. The guidelines and interpretation are constantly evolving and the valuator should remain apprised of all updates regarding the guidelines.
- Work closely with accounting/audit experts during the valuation process since accounting interpretations may have significant implications for the fair value determination.
- Use generally accepted valuation methodologies with respect to the determination of the fair value of business units and intangible assets and keep apprised of changing methodologies and acceptance of those methodologies in the marketplace.

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## 27. How does the role of the valuator impact analysis and reporting?

The valuator may assume different roles in goodwill impairment testing assignments. The valuator could take primary responsibility for completing the impairment testing or could be asked to review impairment testing completed by company management, other specialists or third party valuators. Alternatively, the valuator could be asked to assist in certain components of the goodwill testing process.

The scope of work and reporting requirements will differ based on the role the valuator undertakes. The valuator's scope of review and reporting should be in accordance with the CICBV Valuation Standards. Irrespective of the role assumed, the valuator should always be cognizant of independence issues.

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