Financial Reporting Pressures and the COVID-19 Crisis

Considerations for the Quarter Ending March 31, 2020

Part Four: Testing for Goodwill Impairments

As public registrants prepare their financial reports for the first quarter of 2020, they will be dealing with unique reporting judgments due to the economic impact of COVID-19 and recent government actions. Many of the financial reporting judgments will be especially difficult because of so many unique unknowns such as the duration of the crisis, whether vendors will be able to deliver on commitments, possible accounts receivable collection problems, and other matters that each registrant may be encountering.

To help our clients understand and assess the financial reporting matters under consideration, we are presenting a multi-part series dealing with several of these topics. Today's discussion is Part Four of the series and relates to whether an event has occurred that will trigger the need to test for and possibly record a goodwill impairment charge.

Goodwill balances are assessed annually for impairment, or upon the occurrence of what are referred to in professional guidance as "triggering events." Triggering events are used to identify likely periods when goodwill assets have suffered a loss, thereby requiring a write down.

Reality of Current Events

As a result of the current crisis, the reality for many registrants is that they have experienced at least one the following triggering events, and if the company has goodwill as an asset on their financial statements, they will need to assess whether the asset has been impaired, and if a write down is required:

A) Deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets.

Based on most reports, the current crisis has caused a sharp drop in economic activity and likely the economy has entered into a recessionary period.

B) Deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (absolute terms and/or relative to peers), a change in the market for an entity's products or services, or a regulatory or political development.

Certain industries such as airlines, hotels, and hospitality have been severely impacted as well as certain consumer goods and retailers have also experienced a significant drop in demand.

C) Increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows.

In addition to the disruption to production, product costs for many have increased, efficiencies in the ordinary processes are lost, and many registrants have even lost suppliers and are now seeking alternative vendors.

D) Negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods.

The cumulative impact of the issues above has resulted in declining cash flows for many, along with uncertainty for the duration of the impact.

E) Changes in the composition or carrying amount of net assets, a more-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, recognition of a goodwill impairment loss in the financial statements of a component subsidiary.

Market liquidity concerns appear evident, but little factual information is available.

F) A sustained decrease in share price (absolute terms and/or relative to peers).

The stock markets have dropped significantly in the last couple weeks, and while possibly overstating the consequences of the current crisis, must be assessed as to predictions of value based on the market's assessment for the registrant's future cash flows.

Importantly, a decrease in share price alone, while considered a triggering event, requires careful assessment when resulting from a volatile market. Professional judgment is required to assess the cause of the share price decrease and whether another underlying triggering event may be the root cause for the price drop.

Where does this lead us? Many registrants will be discussing whether they need to test goodwill for impairment. There is significant professional judgment as to how each individual registrant will handle this situation, and certainly the registrant's advisors, legal counsel, and internal and external auditors should be involved.

For the registrants who have experienced a goodwill impairment triggering event and the fair value of a reporting unit falls below the carrying amount at the measurement date, then a write down is required.

Of significance, this is a point in time test, and not something that the registrant can disclose exists, but advocate is only temporary and thereby avoid a write off and impairment.

However, while many registrants may meet the tests indicating an impairment to goodwill exists, due to the extent of uncertainties in measurement, they may not be able to make a reasonable estimate for financial reporting purposes. As such, the registrant will only make disclosures for the event. Interestingly, in later periods when additional information becomes available to prepare an estimate, the evidence may support that the impairment was minimal to nonexistent, and it is not necessary to record an impairment write down. Logically, this is quite different than advocating that the impairment was temporary, although the results would be similar.

The valuation considerations for testing goodwill impairment are complex and beyond the scope of this discussion. If you wish to discuss the valuation considerations in more detail, please let us know.

We hope this discussion is informative and offers practical observations and issues to be aware of when dealing with this unique circumstance arising from the current crisis. If you have questions or suggestions, please let us know. Thank you.