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The Impact of Goodwill Impairment Testing on Earnings per Share

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Abstract

One of the factors that affects the general population in their day-to-day life is share price changes. It is good to note that major accounting practices widely influence the changes in share prices. Goodwill impairment, an accounting charge reported when the fair value of a minority interest or subsidiary is lower than its carrying value, is one of the individual factors that affect the share prices and its earnings. To comply with the demands and needs of investors and regulators, there is an ongoing need to ascertain if the financial statements of a company accurately reflect its earnings and its valuation. Hence, as will be seen below, internal treasury staff and outside auditors periodically compare the balance sheet value of a unit of a company to its fair value. It is also important to note that a goodwill impairment will decrease a company's book value.

Keywords: Asset; Audit; balance sheet; carrying value; fair value; financial statement goodwill impairment; interim period; valuation.

List of Abbreviations

EPS Earnings per share
ASU Accounting Standards Update
SOX Sarbanes-Oxley Act of 2002
NCI Non-controlling interest
CAQ Center for Quality Audit
IFRS International Financial Reporting Standards
FASB Financial Accounting Standards Board

Introduction

Goodwill impairment is an accounting charge reported when the fair value of a minority interest or subsidiary is lower than its carrying value. To comply with the demands and needs of investors and regulators, there is an ongoing need to ascertain if the financial statements of a company accurately reflect its earnings and its valuation. Hence, as will be seen below, internal treasury staff and outside auditors periodically compare the balance sheet value of a company's unit to its fair value.

This test is called goodwill impairment testing. This article will focus on assessing and testing goodwill, goodwill impairments, and their collective impact on a firm's earning per share (EPS). Additionally, this article reviews current methods of goodwill impairment calculation, recent policy guidance on these topics, and

valuation methodology. Finally, we review prevailing accounting standards on goodwill impairment and the views of international standard setters on goodwill impairment. As a percentage of U.S. corporate assets, we note that goodwill has substantially grown over the last few decades, indeed a goodwill bubble!

Goodwill is an intangible asset that arises when one company acquires another. It's usually the excess of the purchase over the sum of the fair value of the company's net assets. As a result, the acquiring company has a higher price than the fair value of the assessed assets. This is usually because the company also acquires other intangible assets that cannot be separately valued. This includes but is not limited to the customer base, excellent employee relations, and the company's reputation. For example, suppose the fair value of the assets of company 'A' minus its liabilities is $20million, and an acquiring company pays $25million to acquire company A. In that case, the goodwill is $5million recorded acquiring company's balance sheet as an intangible asset. According to Calcbench Inc. (2019), firms spend over $2 trillion in mergers and acquisitions each year. Moreover, among the S&P 500 companies in 2019, total goodwill in reported balance sheets exceeded $3 trillion. Further, analysis reveals that the average goodwill firm's goodwill balance has increased by about 35% (Calcbench Inc., 2019)[11]

The Generally Accepted Accounting Principles (GAAP) recommends that goodwill be tested for impairment annually. Goodwill must be tested even more frequently between annual tests if a precipitating event occurs or if circumstances change to indicate that it is more likely than not that impairment has occurred (KPMG, 2020). In testing for impairment, relative valuation metrics such as the price-earnings ratio and discounted cash flow methods help determine a unit's value.

Goodwill impairment is an accounting charge that estimates a differential between a value reported in financial statements and the actual fair value (Kabir, 2017). The most extensive goodwill impairment of $54 billion was recorded in the year 2000 by Time Warner in relation to the acquisition of America On-Line, Inc for $180 billion, which was named one of the largest mergers in the history of America.

Goodwill is tested for impairment at the reporting unit level within a company. A reporting unit refers to an operating segment, as that term is used in ASC 280, Segment Reporting, or one level below an operating segment (referred to as a component) relative to pre-existing terms (Ernst and Young, 2020). The ASC guidance stipulates that indefinite-lived intangible assets and goodwill are tested for impairment annually. The guidance as mentioned above also requires impairment testing regularly subject to external and internal environmental factors affecting the business in the course of the (i.e., a likelihood greater than 50%) that the intangible asset or the reporting unit is impaired[2]. In this regard, during interim periods, ASC 350 requires firms to proactively focus their attention on events or situations that may impair the worth of assets or business units (Ernst and Young, 2020).

Goodwill, as a concept, legitimately captures the cash flow generating potential of items such as intellectual property, acquired and accumulated technology, customer lists and bases, and brand value. On the other hand, impairment defines a situation in which assets acquired no longer generate the financial outcomes or results previously projected at the time they were received. According to Calcbench Inc., about 70% of M&A deals fail to yield the projected returns on the acquired investments (Calcbench Inc., 2020).

According to the Sarbanes-Oxley Act of 2002 (SOX), a firm's management must audit its internal controls relative to financial reporting. Accordingly, relative to goodwill impairment, management ought to determine the availability of appropriate controls geared towards mitigating the risks that characterize sequential goodwill impairment testing, including; triggering event considerations, carrying value and fair value calculations (if a quantitative goodwill test is performed) and, if applicable, the details of the impairment charge calculation (CAQ, 2020)[3]. Furthermore, management is required to determine goodwill for impairment annually and when a

[1] The Current State of Goodwill & Impairments (2019), moderated by Matt Kelly CEO Radical Compliance. Pranav Ghai, co-Founder and CEO Calcbench, and PJ Patel, co-CEO Valuation Research Corporation, discuss corporate goodwill, goodwill impairment, and financial analysis techniques that analysts can use to assess the value of goodwill

[2] The ASA guidelines implicitly state, "Assets are generally subject to an impairment review only if there are indicators of impairment. IAS® 36, Impairment of Assets lists examples of circumstances (market value declines, negative changes in technology, markets, economy, or laws, increases in market interest rates, and when company share price is below the carrying amount) that would trigger an impairment review"

[3] According to the Center for Audit Quality, management is required to assess goodwill impairment annually and when a triggering event occurs. This resource may be useful in considering the impact COVID-19 may have on certain aspects of

triggering event occurs (CAQ, 2020), with the subsequent charge correctly factored in and reflected in the company's financial statements.

Methodology

Salient Current Thoughts on Goodwill Impairment

1. Goodwill impairment and accounting under IFRS 3: Business Combinations-Rules

There are two main methods of calculating goodwill: the full goodwill method and the proportionate method. The full goodwill method is based on comparing the fair value of assets of the subsidiary to be acquired and the fair value paid as consideration by the parent. Thus, the full goodwill method considers the proportion spent by the parent as consideration and the proportion paid by the non-controlling interest (NCI). On the other hand, the proportionate method considers the proportion of fair value consideration paid by the parent and the fair value of the proportionate assets that the parent acquires (Carlin, 2008). Goodwill impairment usually requires goodwill to be written off first unless specific intangible assets are written off before goodwill.

Under IFRS 3, intangible assets are recognized separately in an acquisition combination of businesses instead of including such intangible assets in the goodwill. The acquisition method is typically employed and requires the assets, liabilities, and any other obligations to be included and measured at their fair values at the time of acquisition (BDO global, 2018).

2. Goodwill impairment and accounting under IAS 36: Impairment of Assets-Rules

IAS 36 defines the requirements that are to be reported and an account of all financial assets. It provides instructions that guide accounting professionals on how to conduct impairment testing. IAS 36 provides for the impairment testing of tangible as well as intangible assets. Asset valuations should not exceed their recoverable amount. To achieve this objective, the standard requires companies to test all assets within a bracket of probable impairment when any impairment indications exist (Ernst and Young, 2010).

3. Potential changes to accounting standards on Goodwill Impairment-Prospective Rules

In 2020, the new FASB goodwill impairment steps were initiated for publicly traded companies. The steps sought simplification, although the accuracy of goodwill impairment measurement for respective entities. Companies should review their legacy processes, as well as internal controls for measuring asset impairment. In addition, there should be a process in place to anticipate impairment-causing events and environmental factors. Given the economic outlook and the various aspects of macroeconomic, taxation, political change, and pandemic controls, it would be prudent to adopt regular reviews of company measurement of goodwill impairment (Kabir, 2017). The guidance requires that both indefinite-lived intangible assets and goodwill are tested for impairment annually and interim period testing if events or changes in circumstances indicate that it is more likely than not (i.e., a likelihood greater than 50%) that the intangible asset or the reporting unit is impaired[4]

Therefore, during intra-year periods, under Accounting Standards Codification (ASC) 350, it is required companies to direct their interests towards events and circumstances influencing significant inputs used in the assessment of the fair value of the asset, asset group, or reporting unit to ascertain whether an interim quantitative impairment test is deemed necessary (Ernst & Young, 2020).

4. The Goodwill Bubble Theory-Is the Aggregate Value of Goodwill Surprisingly High

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accounting for goodwill impairment.

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

According to Calcbench Inc. (2019), the aggregate amount of impaired goodwill in 2018 was $64 billion. For example, out of the $64 billion, G.E. alone recorded $22 billion in goodwill impairment, while Craft Time reported $ 7 billion in goodwill impairment. Evaluating goodwill for the totality of S&P 500 companies, Calcbench, through an evaluation of total assets and stakeholder's equity, mapped the percentages cumulatively from 2008 to 2019. A cross-industry analysis revealed that amid the COVID-19 pandemic, companies in hospitality, hotel, and tourism might experience a burst in their goodwill bubble, i.e., a massive write-down in their goodwill accounts following a pandemic-induced business slowdown. On the contrary, companies in the online retail industry, telecommunications, and logistics sectors are likely to experience significant growth, thus sustaining their participation in the goodwill bubble. On the other hand, the real estate market, especially commercial office buildings, is most likely to suffer severe financing and logistical difficulties (Calcbench Inc., 2020). Thus, we see that impairment in goodwill relative to the COVID-19 pandemic varies significantly by industry.

Goodwill Impairment is relevant to earnings per share calculations

The share prices are usually dependent on the company's earnings. The investors use these earnings to project the future cash flows, which are then factored in the value of the stocks. Using the discounted cash flow method, which determines the price of a share by first summing up the total cash flows of a company in a given period, is how we calculate the projected cash flows. The price-earnings multiple or the price-to-earnings ratio is used to assess the value of the stock. Goodwill impairment is recorded as a loss reducing the net income and consequently reducing the company's earnings. Since this might reflect the many aspects of the company's future profitability, it eventually reduces the expectations of future cash flows. When the future cash flows decline, the share prices also reduce because their value is determined using the discounted cash flow method and the price-earnings multiple. Since goodwill impairment affects the expected future cash flows and earnings, which then directly influences the share prices, it is dimmed to mean that goodwill impairment is directly related to a decline in share prices.

The routine annual review of goodwill mandated by the Sarbanes-Oxley Act of 2002 (SOX) through impairment testing facilitates the correct calculation of goodwill, thus increasing balance sheet integrity. Goodwill is never revalued in an upward direction. Therefore, any impairment is treated as an expense in the income statement. Goodwill impairment is not proportionate or systematic, which is why it cannot be apportioned in an easily predictable annual fashion (ACCA Global, 2019)[5]. This feature motivates interim review testing of goodwill levels.

Goodwill impairment affects the overall value of a company's shares. The fair value calculations underlying goodwill impairment analysis are complex and challenging for an investor to assess even when the corporate disclosures are transparent. To illustrate, Morse (2019) offers the example of Amazon's purchase of Whole Foods market. In that transaction, 70% of the purchase price was allocated to goodwill. Such a high proportion of goodwill could be puzzling to investors and might also be especially prone to impairment in subsequent years. One example might be COVID-19 pandemic issues. While assessing the company's goodwill lines, auditors may have to conduct additional or different procedures deviating from conventional practices (CAQ, 2020). For example, auditors may consider the COVID-19 pandemic a triggering event and perform goodwill impairment testing when performing interim analysis.

Market reaction to goodwill impairment depends on the market's ability to foresee such incidents. In a regime of efficient markets, analysts "ballpark" the value of acquired assets (Kwon & Wang, 2019). Therefore, businesses are expected to make sure that the value of these assets is well-calculated and that these resources are valued at their fair market value (Kwon & 10Wang, 2019). Still, there remains the possibility of incorrect valuation,

[5] Specifically, the Association of Chartered Certified Accountants reports that; “Under the Sarbanes-Oxley Act of 2002 management is required to assess the effectiveness of their internal controls over financial reporting. Specific to goodwill impairment, management will need to assess if they have the appropriate controls in place to address the risks associated with each step of goodwill impairment testing. While there have been no changes to these requirements, management should consider if their internal controls are appropriately designed and operating at a precise enough level to detect a material misstatement in the current environment.”

leading to a write-down of these assets. Based on how correct goodwill is calculated, several results could be expected.

First, a concise and correct valuation of goodwill could influence stakeholders to invest more in the company. Since goodwill is a type of intangible asset, the valuation of the company reflects its cash flows. Conversely, the company's valuation could be impaired if goodwill valuation is incorrect, and analysts voice a more general sort of pessimism. For instance, measures such as return on assets would diminish if the valuation of a company's goodwill is incorrectly stated and restated through impairment (Kwon & Wang, 2019). According to Calcbench Inc. (2020), goodwill represents over 40% of large corporate balance sheets. Thus, impairment charges against earnings remain a significant cautionary feature within the market analyst community.

Data Analysis

According to "Audit analysis" by Nicole Hallas (2019), we refer three companies to show the effects of goodwill impairment on the stock earnings of a company.

Kraft Heinz Co. [KHC], a consumers' staples company, recorded a massive goodwill impairment of $15.9billion in 2019. This eventually led to a decline of its market capitalization by 30%. The closing stock price of the company's shares as at 31 December 2018 was $43.64 compared to $32.13 as at 31 December 2019.

Newell Brands [NWL], a consumer Discretionary company, reported an $8.3billion goodwill impairment charge to its assets in its 2018 annual report. This represented 96% of its market capitalization. The company's closing stock price as at 30 December 2019 was $17.92 compared to $18.59 as at 31 December 2018.

Coty Inc. [COTY], a beauty company, reported a $3.8billion goodwill impairment in its 2019 fiscal year. This was a 43% representation of its market capitalization. The stock's closing price at 31 December 2018 was $6.56 compared to $11.25 as at 31 December 2019.

From the above analysis, it's easy to note that goodwill impairment can be either positive or negative. For example, for Kraft Heinz Co. [KHC] and Newell Brands [NWL] the impairment had a negative effect while it had a positive impact on Coty Inc.

Conclusion

Kraft Heinz Co. [KHC] impairment test was triggered by short-term developments in the second part of 2018. This was quite unusual given that significant write-offs happen from long-term trends. Newell Brands' [NWL] impairment was primarily contributed by factors like bad weather, higher shipping costs, and increased competition. From the above analysis, companies and investors must pay attention to economic consumer changes that may affect the companies' stocks. They must also pay attention to changing macroeconomics conditions.

Goodwill valuation rests at the core of every acquisition. While fair market value for assets acquired may not represent the actual value of the acquired company, it is essential to pay close attention to the valuation methods, market preparedness, and expected results from goodwill valuation changes after any acquisition. The accuracy of the valuation process can positively or negatively affect a company (Kwon & Wang, 2019). Goodwill can be calculated as part of the firm value, highlighted, and observed; the calculated value of a firm is compared with 12 the fair value to identify and report any goodwill impairment. If the estimated value is lower than the fair value of the subsidiary or minority interest reported, impairment is realized.

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