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Valuing Goodwill: US Not-For-Profits Prepare for Annual Impairment Testing

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Recently updated US accounting standards raise the bar for not-for-profit healthcare organizations. Accounting Standards Codification (ASC) 350 (Intangibles – Goodwill and Other) and ASC 360 (Property, Plant, and Equipment) no longer apply only to for-profit entities. This change is set to have a dramatic impact, especially in the healthcare sector, as not-for-profits gear up for annual testing of goodwill impairment.

What do the changes mean?

Assets are no longer confined to tangible assets (such as land and buildings); they also include intangible assets such as patents, intellectual property, brand names, non-compete agreements, and licenses.

Any not-for-profit entity that has made an acquisition since 1 January 2010 is likely to have recorded goodwill and intangible assets as part of that transaction. Under ASC 350, not-for-profit organizations are now required to test goodwill and certain intangible assets for impairment at least annually, and to determine their respective fair values.[1] Fair value can be viewed as the market price for an asset, as determined by market participants, at the date of measurement, and thus may differ from the book value.

HYPOTHETICAL EXAMPLE OF TWO-STEP PROCESS FOR GOODWILL IMPAIRMENT TESTING

Step 1:
Determine fair value of entire reporting unit (the component of the entity that has recorded goodwill). Compare fair value of reporting unit to book value (net assets or equity) of reporting unit.

Fair value of reporting unit exceeds book value >> No goodwill impairment is indicated. Fair value of reporting unit less than book value >> Potential goodwill impairment is indicated, and Step 2 is performed.

Step 2:
The impairment amount is not determined by comparing the book value ($160 in example) and fair value of reporting unit ($150 in example).

First, determine separate fair values of each asset and liability other than goodwill. Next, determine implied value of goodwill by assigning amount that will cause net fair value of all assets and liabilities to equal fair value of reporting unit.

The impairment amount is $15 in the example, or the difference between $20 (book value) and $5 (fair value) of goodwill.

	Step 1	Step 2		
	Book Value	Fair Values Other Than Goodwill	Fair Values	Impairment
Current assets	$115	$115	$115	
Tangible assets	$50	$55	$55	
Intangible assets	$25	$30	$30	
Goodwill	**$20**	**–**	**$5***	**$15**
Other assets	$5	$5	$5	
Total assets	$215	$205	$210	
Current liabilities	$10	$10	$10	
Long-term liabilities	$45	$50	$50	
Total liabilities	$55	$60	$60	
Net assets (book value)	**$160**	**$145**	**$150**	
Fair value of reporting unit	**$150****	**$150**	**$150**	

* Implied value of goodwill to balance net fair value to fair value of reporting unit.

** Since fair value of reporting unit of $150 is less than book value of $160, there is potential impairment and Step 2 is required.

1 ASC 350 includes the accounting guidance formerly known as Statement of Financial Accounting Standards (SFAS) Statement No. 142.

Historically, not-for-profit entities recorded assets gained in an acquisition or merger at book value. ASC 958 now requires that upon an acquisition, an organisation must allocate the purchase price to the assets of the acquired entity. The purchase price less the fair value of separately identifiable assets is recorded as goodwill.

Two-step process for goodwill impairment testing

Impairment testing for goodwill is a two-step process, beginning with a thorough analysis that requires fair value estimates and a yes-or-no determination of impairment. If the answer to Step 1 is affirmative, the healthcare organization needs to proceed to Step 2 and determine the magnitude of the impairment.

Step 1: initial analysis. Test for impairment of goodwill, using the fair value standard. Does fair value of the applicable reporting unit exceed the carrying (book) value? If so, there is no impairment and the annual testing process is complete. But if the book value of a reporting unit is greater than fair value, then the second step is necessary.

Step 2: calculation of magnitude. After determining in Step 1 that impairment exists, a healthcare organization should determine the fair value of all its individual assets and liabilities, including tangible assets (such as land, buildings, and equipment), intangible assets, and any contingent liabilities. The process is similar to the valuation and accounting required in a purchase price allocation after an acquisition transaction is completed. In the case of impairment testing under Step 2, these fair values are not recorded in the financial statements; rather, the values are used only to determine the amount of goodwill.

Next, the implied fair value of goodwill is determined by comparing the Step 1 fair value of the reporting unit with the total Step 2 fair value amounts assigned to all assets and liabilities (other than goodwill). The excess of the fair value of the reporting unit (Step 1) over the total fair value assigned to net assets and liabilities (Step 2) is the implied fair value of goodwill.

If the implied fair value of goodwill is less than the carrying amount of goodwill, the organization takes an impairment charge to reduce goodwill to the implied fair value. This adjusted carrying amount is the new accounting basis of goodwill, and the impairment loss may not be reversed in future periods.

The table on page 2 shows a hypothetical example of the two-step process for goodwill impairment testing.

Two-step process for amortizable intangible assets

Impairment testing for amortizable intangible assets is also a two-step process, but it differs from the process for goodwill. In contrast to ASC 350, where fair value is the sole standard for goodwill, ASC 360 also prescribes the use of undiscounted cash flows to test amortizable intangible assets (that is, assets with a finite life, such as a medical device patent or a covenant not to compete) for recoverability.[2]

Another significant difference is the use of *market participant* assumptions for purposes of ASC 350 and *organization specific* assumptions for the purposes of recoverability under ASC 360. Finally, rather than an annual impairment test, intangible assets are tested for impairment when an event or a change in circumstances indicates that the carrying amount might not be recoverable.

To test intangible assets subject to amortization, organizations need to compare undiscounted cash flows expected to result from the use of the asset – or an asset group – with the carrying value. If the undiscounted cash flows exceed carrying value, no further steps are required. However, if the sum of undiscounted cash flows is less than carrying value, an impairment loss would be recorded to the extent that the carrying value exceeds the fair value of the asset or asset group. Thus, for amortizable intangible assets, the two-step process involves comparing both the undiscounted cash flows and the fair value to determine impairment.

The table on the following page shows a hypothetical example of the two-step process for amortizable intangible assets.

Most intangible assets can be amortized

Most intangible assets have limited lives. A research institution, for example, might have patents that expire after a given time. Even in the case of unpatented proprietary technology, the asset typically has a limited economic life, especially in the medical field, where procedures are continually being improved.

The valuation process requires well-reasoned judgment. A health system might have a well-known name but abandon this brand for other reasons. For example, in 2010, the Clarian Health system of Indiana in the US decided to realign with the Indiana University Health brand name. This change could considerably increase the market value of the Indiana University Health brand while diminishing the Clarian brand.[3]

2 ASC 360 includes the accounting guidance formerly known as SFAS No. 144.
3 Wall, J. K., "Clarian Hospital System to Adopt IU Name", Indianapolis Business Journal, May 5, 2010.

HYPOTHETICAL EXAMPLE OF TWO-STEP PROCESS FOR AMORTIZABLE INTANGIBLE ASSETS	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Revenue from patented medical device	$100.00	$90.00	$80.00	$70.00	$60.00	$50.00	$40.00
x Market royalty rate = Royalty income 5%	$5.00	$4.50	$4.00	$3.50	$3.00	$2.50	$2.00
Tax-effected royalty income stream 40%	$3.00	$2.70	$2.40	$2.10	$1.80	$1.50	$1.20
Sum of undiscounted royalty cash flows	**$14.70**						
Step 2: Tax-effected royalty income stream	$3.00	$2.70	$2.40	$2.10	$1.80	$1.50	$1.20
Time periods	0.5	1.5	2.5	3.5	4.5	5.5	6.5
Hypothetical discount rate/present value factor 15%	0.9325	0.8109	0.7051	0.6131	0.5332	0.4636	0.4031
Present value	$2.80	$2.19	$1.69	$1.29	$0.96	$0.70	$0.48
Sum of present values	$10.11						
Benefit from tax amortization	$2.03						
Fair value of patent	**$12.13**						

Example 1: Book value of patent is $10. Sum of undiscounted cash flows is $14.70. No impairment is indicated.
Example 2: Book value of patent is $20. The sum of discounted cash flows is $14.70. Impairment is indicated (Step 1).
The fair value of the patent is determined in Step 2 and is $12.13.

The impairment charge is calculated as:

Book value of patent	$20.00
Fair value of patent	-$12.13
Impairment charge	$7.87

An exception to annual testing

Some not-for-profit healthcare organizations considered performing impairment testing at the 2010 calendar year-end. Other finance executives decided this issue could wait until 2011. For example, if an organization made an acquisition that closed on 1 July 2010, annual impairment testing would not need to be conducted until one year later. However, most organizations recognize that the annual impairment test is best performed well in advance of the fiscal year-end. The advantage is that if impairment exists, the organization has sufficient time to perform a thorough Step 2 analysis without delaying the completion of year-end financial statements and the annual audit.

However, exceptions in annual testing arise in the case of triggering events, which can affect both not-for-profit and for-profit organizations. Adverse changes in the business climate or market that may have a negative impact on the value of the organization – or on recoverability of intangible assets – are generally considered to be triggering events.

For example, take the case of Hospital A, which recently purchased Hospital B. The acquiring organization expected Hospital B to generate a certain level of earnings. In reality, Hospital B has been losing money since the acquisition – an example of a triggering event that calls for impairment testing.

Caution: expertise required

Some organizations conduct impairment analyses in-house. While they may save some time and expense initially, they might need to employ an external audit firm to review the quality of the work. Typically, the parties conducting the analysis are expected to write a formal memorandum outlining the processes followed and document potential shortcomings.

External audit firms tend to have their own valuation specialists reviewing impairment analyses. They look for overall soundness and whether the analysis is cohesive and technically correct. Some common shortfalls that auditors find are a lack of overall support for the impairment analysis, especially with respect to rates used in discounted cash flow models. Errors on forecasts are also fairly common.

For example, amortization charges that are allowed to continue indefinitely, rather than terminating at the end of the life of the asset, can affect earnings. In addition, errors with respect to working capital calculations and capital charges are fairly common. When a discounted cash flow model is used to test goodwill impairment, the external auditors are likely to ask if that model contemplates an asset sale or stock sale. They will test whether an organization has correctly captured the nuances between those two structures in the discounted cash flow model.

Errors are not limited to discounted cash flow models. Healthcare organizations can make errors in calculating valuation multiples. For example, total value to earnings before interest, taxes, depreciation, and amortization (EBITDA) may not match the right time periods, or the healthcare organization may be comparing itself to another organization that is not reasonably similar.

Consequently, public and private healthcare organizations may benefit from expert advice in conducting impairment studies. Healthcare organizations should work closely with valuation specialists, accountants, and external auditors to address the requirements of ASC 350 and ASC 360 before starting their analyses.

Non-compliance with the accounting requirements is unwise, and could result in a qualified audit opinion. A qualified opinion from external auditors can limit an organization's ability to obtain bank financing. It may also weaken bond financing options, affect existing bond and loan covenants, and raise questions about the quality of corporate governance.

Don't leave it too late

Because of the detailed issues and nuances in valuing goodwill, it is a mistake to leave this task to the last minute. Depending on the complexity of the healthcare organization, the valuing process can take several weeks. In a best-case scenario, the organization finds no impairment and can complete the work within a reasonable timeframe. However, if impairment is indicated, the quantification of impairment can take several months to complete, depending on the complexity of the situation.

Consequently, healthcare organizations should consider starting this process at least two months in advance of a deadline, and ideally several months before the end of the organization's fiscal year. Because auditors customarily review the valuation work performed by an organization or that of the organization's valuation specialist, organizations should allow time for back-and-forth information exchanges, so the audit firm is comfortable with the valuation work and documentation related to impairment testing. Waiting too long can cause organizations to miss audit deadlines, which can affect bond ratings and undermine reputation – a key asset for healthcare organizations.

For more information:

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