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Goodwill Non-Impairments

Evidence from Recent Research and Suggestions for Auditors

By Dennis Chambers and
Catherine Finger

“Is there any point to which you would wish to draw my attention?”

“To the curious incident of the dog in the night-time.”

“The dog did nothing in the night-time.”

“That was the curious incident,” remarked Sherlock Holmes.

The legendary fictional detective Sherlock Holmes, in this excerpt from “Silver Blaze” by Sir Arthur Conan Doyle, illustrates that the absence of something, when it is expected, can provide strong evidence of actions not directly observed. This article extends Holmes’s thinking to the case of goodwill accounting. Recent academic research provides evidence about curious incidents of “goodwill non-impairment”—that is, the absence of goodwill impairment losses when, like a dog barking, they are expected.

When Statement of Financial Accounting Standards (SFAS) 142 was proposed as a possible replacement for goodwill amortization, some academics and practitioners were concerned that the unverifiable fair value estimates used to measure goodwill impairment losses would provide an opportunity for companies to manage earnings by delaying the recognition of impairment losses. After SFAS 142 was enacted in 2001, accounting researchers had to wait until enough years of earnings data existed to look for evidence of goodwill-related earnings management. Only now, with the recent release of three working papers, are we getting a first glimpse into the existence of goodwill non-impairment and how companies use the discretion in the goodwill standard to manage earnings. This article discusses these three studies within the context of *Exhibit 1*, which presents reporting possibilities for companies that have goodwill assets. The columns describe whether

the goodwill has become impaired; the rows describe the accounting choice made by the firm in response.

If the economic value of a goodwill asset has decreased, then the goodwill has

goodwill impairment losses are absent when they would cause company earnings to be negative or would cause earnings decreases. Impairment losses are also absent when they would decrease CEO



become impaired (Exhibit 1, first column). Goodwill impairment standards require companies to report the current-year decline in value as a loss in current-year net income. Companies that follow the standards would be in box A. Companies with impaired goodwill that choose to either not report the loss or report an understated loss would be in box B (i.e., goodwill non-impairment). Firms in box B may have used accounting discretion to avoid reporting a loss; nevertheless, they are not following the intent of the impairment reporting standard.

The three studies report evidence that goodwill non-impairment does exist (i.e., that there are firms in box B). In addition, the non-impairment is associated with incentives managers have to overstate earnings. They find evidence that recorded

compensation, damage CEO reputations, and cause bond covenant violations. Finally, evidence suggests that an impairment loss is not recorded at the time a goodwill asset generates cash flows, as implied by economic theory, but rather much later. Therefore, these studies indicate that early concerns of academics and practitioners were warranted; companies appear to be using the discretion in goodwill impairment reporting standards to manage earnings.

Goodwill Accounting Standards

In June 2001, FASB enacted two standards related to the accounting for goodwill. The first, SFAS 141 (now found in ASC section 805-30), required that business acquisitions would henceforth be accounted for using the purchase method.

Under the purchase method, the purchaser compares the fair value of all acquired net assets (total identifiable assets minus liabilities) with the sum of the fair value of consideration paid for the acquisition. The difference is accounted for as a goodwill asset at the time of the purchase. (Recently, FASB has modified these procedures, now calling them the acquisition method; however, the modifications were enacted after the sample periods of the three studies described here.)

The second goodwill-related accounting standard was SFAS 142 (now found in ASC section 350-20). This standard abolished systematic amortization of goodwill and instituted a procedure for annual goodwill impairment testing. Impairment testing is carried out at the reporting unit level; a reporting unit is defined as a portion of the company one level lower than the segment level (management decides how much goodwill to allocate to each reporting unit).

SFAS 142 specified the following procedure for annual goodwill impairment testing. The company estimates the fair value of a reporting unit and compares it with the unit's book value—including the book value of goodwill. If the unit's fair value is less than its book value, then an impairment has taken place. A second step is required to determine whether the goodwill asset is the source of the impairment. The company estimates the implied fair value of the unit's goodwill by subtracting the fair value of the non-goodwill net assets from the unit's total fair value—the residual equals the implied fair value of goodwill. If the implied fair value of goodwill is less than the goodwill's book value, then the goodwill is impaired and the impairment is equal to that difference. The impairment losses across all units are aggregated and recognized, resulting in a reduction of reported net income.

Discretion in Goodwill Accounting

The process of testing goodwill assets for impairment involves many opportunities for exercising accounting discretion and potentially permits income manipulation. First, the initial goodwill asset recorded under the purchase method and the allocation of the goodwill to reporting units require the application of accounting discretion. Next, because reporting units are not traded separately in the stock market,

verifiable unit fair value measures are not available. Thus, each unit's value must be based on difficult-to-verify estimates of its future cash flows—cash flows that are themselves a product of management's future decisions and actions as well as unpredictable future macroeconomic forces. In addition, estimates of the fair value of the individual non-goodwill assets and liabilities are necessarily based on unobservable Level 3-type inputs. (According to ASC section 820-10-35, Level 3 inputs consist of unobservable characteristics and assumptions, as compared to Level 1 and 2 inputs, which include actual prices or other verifiable characteristics.)

Therefore, the process of testing goodwill for impairment gives significant discretion to management. If a company's goodwill has become impaired, but executives want to avoid recording an impairment loss, they can manipulate their estimates to suggest the goodwill is not impaired and argue that judgment justifies their unimpaired goodwill measure. In addition, the estimates are difficult for an auditor to question because they are based on unverifiable characteristics, assumptions, and cash flow projections that are presumably within the special expertise of management. Consequently, the potential for manipulation of impairment loss, and therefore reported net income, is very great.

Concerns Expressed Before SFAS 142

When FASB issued the exposure draft for its proposed goodwill accounting standards, it found significant opposition. Eric E. Lewis, Jeffrey W. Lippitt, and Nicholas J. Mastracchio Jr. noted that comment letters sent to FASB were highly critical of the discretion afforded preparers' estimates of fair values ("Users' Comments on SFAS 141 and 142 on Business Combinations and Goodwill," *The CPA Journal*, vol. 71, no. 10, 2001, p. 26). Responders criticized the

use of fair value estimates to determine goodwill value, expressing concern that the proposed estimates were not sufficiently reliable to justify the recording of asset value changes. Mark F. Massoud and Cecily A. Raiborn predicted that the "significant leeway" given to companies to value goodwill would lead to earnings management ("Accounting for Goodwill: Are We Better Off?" *Review of Business*, vol. 24, no. 2, 2003, p. 26). Ross L. Watts also argued that the discretion given in the new goodwill standard opens the possibility of earnings manipulation: "Assessing impairment requires valuation of future cash flows. Because those future cash flows are unlikely to be verifiable and contractible, they, and the valuation based on them, are likely to be manipulated" ("Conservatism in Accounting Part I: Explanations and Implication," *Accounting Horizons*, vol. 17, no. 3, 2003, pp. 207–221).

These articles articulate the deep concern many had that the discretion afforded to companies by SFAS 142 would result in earnings manipulation. We now discuss evidence that these concerns were justified based on one specific type of earnings manipulation: goodwill non-impairment (i.e., not recording a correct impairment loss when goodwill has become impaired—Exhibit 1, box B).

Results from Recent Research

Goodwill non-impairments related to earnings benchmarks. A large body of accounting research has found evidence that companies tend to manage their earnings upward to avoid reporting a loss or a reduction in earnings (e.g., see David Burgstahler and Ilia Dichev, "Earnings Management to Avoid Earnings Decreases and Losses," *Journal of Accounting & Economics*, vol. 24, no. 1, 1997). The author (Dennis Chambers, "Earnings

EXHIBIT 1 Reporting Possibilities for Companies That Have Goodwill Assets		
	Goodwill is impaired	Goodwill is not impaired
Goodwill loss is correctly recorded	Box A: No earnings management	Box C: No earnings management
Goodwill loss is reduced or not recorded	Box B: Upward earnings management	

Management by Avoiding or Reducing Goodwill Impairments,” working paper, 2010) asks whether firms use goodwill impairment accounting to manage their earnings in this setting. He refers to the earnings management targets where earnings go from positive to negative (i.e., zero earnings), and where earnings changes go from positive to negative, as earnings “breakpoints.” Chambers looks for evidence that firms avoid or reduce goodwill impairments in order to report earnings that are above these breakpoints.

To explain a potentially measurable result of such earnings management, consider a hypothetical set of 500 firms that

would report earnings below a breakpoint in the absence of earnings management. Of those 500, suppose 100 have impaired goodwill and, as such, their earnings should include a goodwill impairment loss. In the absence of earnings management, 20% of the firms below the breakpoint (100/500) should report an impairment loss. Now, suppose that of the 100 with impaired goodwill, 40 choose to report either no impairment loss or a reduced loss, allowing those firms to report earnings above the breakpoint. In this case, only 13% of the remaining firms below the breakpoint (60/460) would be reporting an impairment loss. Chambers’ study examines the firms

just below the breakpoints to see if there are fewer than expected goodwill impairments among those firms, as evidence of goodwill-based earnings management. (Chambers notes that he could also look for evidence of earnings management among the firms just above the breakpoint, but the effect on the percentage of firms impairing goodwill would be significantly less and therefore harder to measure.)

Using several advanced statistical methods to measure the occurrence and size of goodwill impairments, Chambers finds that among the firms just below the zero earnings breakpoint, the number impairing goodwill is 48.8% lower than expected. Similarly, he finds that among the firms reporting earnings just below the zero change-in-earnings breakpoint, the number with goodwill impairments is 19.9% lower than expected.

Chambers also finds that the average company with a reported goodwill asset impairs 14.6% of that asset in any given year. However, companies reporting earnings just below zero impair far less of their goodwill—an average of 1.5%. In the same way, companies reporting a small reduction in earnings—those just below the earnings-change breakpoint—report goodwill impairments that are 6.7 percentage points lower than average.

Overall, Chambers’ findings are consistent with companies avoiding reporting impairment losses that would cause earnings to go negative or would cause a decrease in earnings relative to the previous period. This is strong evidence that companies manage earnings by avoiding or reducing goodwill impairments when they have incentives to report positive or increasing earnings.

Goodwill non-impairments related to CEO reputation, CEO compensation, and debt covenants. Karthik Ramanna and Ross L. Watts (“Evidence on the Use of Unverifiable Estimates in Required Goodwill Impairment,” 2010, working paper), describe how FASB expected that managers, under SFAS 142, “will, on average, use estimates of goodwill’s fair value to convey private information on future cash flows. In contrast, agency theory predicts managers will on average use unverifiable discretion, such as that in goodwill impairment tests, opportunistically.” Ramanna and Watts examine

EXHIBIT 2
Results of Related Recent Working Papers

Authors and Journal Information	Description of Sample	Main Results
Dennis Chambers, “Earnings Management by Avoiding or Reducing Goodwill Impairments,” 2010	16,913 company-year observations, representing 4,737 US domiciled companies with material goodwill assets during the years 2004 through 2008.	Companies tend to avoid or reduce goodwill impairments when the impairment would result in the company reporting a loss or a reduction in net income.
Karthik Ramanna and Ross L. Watts, “Evidence on the Use of Unverifiable Estimates in Required Goodwill Impairment,” 2010	124 firms between the years 2003 and 2006 with a high likelihood of goodwill impairment based on large goodwill asset and high book-to-market ratio.	Contrary to FASB expectations, managers do not appear to be conveying positive private information when they choose not to record goodwill impairment losses. Goodwill impairments are absent when they would decrease CEO compensation, damage CEO reputations, and potentially cause bond covenant violations.
Kevin K. Li and Richard G. Sloan, “Has Goodwill Accounting Gone Bad?,” 2009	23,224 company-year observations over the years 2000 through 2007.	Goodwill impairments tend to be delayed until there is little if any value remaining in the goodwill asset, rather than being impaired as the value decreases.

whether goodwill non-impairment is associated with either positive private information or opportunistic behavior by selecting a sample of firms for which the market may expect impairments. Within that group of firms, they then compare the characteristics of firms that record a goodwill impairment loss (i.e., box A) with the firms that do not (i.e., boxes B and C).

Goodwill non-impairment is justified when managers legitimately believe, based on positive private information, that the current book value of goodwill does not overstate its fair value (i.e., box C). Ramanna and Watts assess whether managers' positive private information is associated with goodwill non-impairment. They measure positive private information by looking for company stock repurchases and insider buying activity—each of these would be indications that management believes the company's stock is undervalued. They also use advanced content analysis to measure the extent to which management includes "achievement-related words" in the companies' 10-Ks. Higher numbers of such words are interpreted as greater positive private information. They find no significant relation between any of their measures of positive private information and the recording of goodwill impairment losses. This result is inconsistent with managers using goodwill accounting discretion to convey their positive private information, as intended by FASB.

Ramanna and Watts then assess whether potential earnings management behavior is related to goodwill non-impairment (i.e., box B). Specifically, they examine a number of characteristics likely to create incentives to delay impairments. These include high stock price sensitivity to earnings, exchange listing requirements sensitive to goodwill impairments, long CEO tenure (as a proxy for CEO reputation), and debt covenants and CEO compensation contracts that are sensitive to goodwill impairments. They find no evidence that stock-price sensitivity or exchange listing requirements are associated with goodwill non-impairments. Among the non-impairing firms, however, they find a statistically higher proportion with goodwill-inclusive debt covenants, goodwill-inclusive CEO compensation contracts, and longer CEO tenure.

Overall, Ramanna and Watts find little evidence that managers use the discretion

in goodwill accounting as FASB intended: to convey private information about goodwill assets. Instead, they find evidence consistent with managers managing goodwill impairment losses in order to reduce debt covenant violations, increase CEO compensation, and protect CEO reputation.

Goodwill non-impairments related to cash flows. Kevin K. Li and Richard G. Sloan ("Has Goodwill Accounting Gone Bad?" 2009, working paper) examine

They find evidence consistent with managers managing goodwill impairment losses in order to reduce debt covenant violations, increase CEO compensation, and protect CEO reputation.

whether goodwill impairments occur in a timely way. The fair value of goodwill, as with any asset, should be equal to the present value of the future cash flows expected to be gained from the goodwill asset. Therefore, ironically, goodwill should lose the most value (and impairment losses should be greatest) in the periods when the largest cash flows from goodwill are realized (consistent with the matching principle).

Li and Sloan use advanced statistical techniques to examine whether goodwill impairment losses are recorded at the time when they are expected (i.e., when high positive goodwill-related cash flows are realized). Contrary to expectations, impairment losses are associated with poor company performance—low positive or negative goodwill-related cash flows. In other words, companies appear to delay the

recording of goodwill impairment losses until the related cash flows are almost exhausted, long after the fair value of the goodwill has been lost.

Implications for Auditors

When FASB issued the exposure draft that eventually became SFAS 142, there was great concern that the discretion given to companies to value goodwill would result in companies using manipulated goodwill impairment losses to manage earnings. Now that sufficient years have passed since the enactment of SFAS 142, accounting researchers have begun to look for evidence that those concerns were justified. Although no studies have yet been published, the three recent working papers described in this article provide strong initial evidence that companies are indeed using their discretion in determining goodwill fair value to delay or reduce goodwill impairments in order to manage earnings.

It behooves auditors and investors alike to give special attention to the goodwill assets of companies reporting earnings, or a change in earnings, just above zero. These companies have strong incentives to manipulate goodwill impairment testing to avoid reporting a loss or a reduction in earnings. Similarly, auditors should carefully examine goodwill fair value measures when related impairments would lead to losses that would significantly decrease CEO compensation, damage CEO reputations, or violate bond covenants. Finally, if a company has high cash flows that appear to stem from goodwill assets, auditors should make sure the corresponding impairment of goodwill fair value has also been recorded. Based on these recent academic studies of goodwill impairment, it is likely that at least some companies are manipulating their impairment testing to delay or reduce goodwill impairments consistent with opportunistic earnings management. □

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