June 21, 2011

Ms. Leslie Seidman
Chair
Financial Accounting Standard Board
401 Merritt 7 (P.O. Box 5116)
Norwalk, CT
06865-5116

Re: Testing for Goodwill Impairment (File Reference No. 2011-180)

Dear Ms. Seidman,

The CFA Institute[1], in consultation with its Corporate Disclosure Policy Council ("CDPC")[2], appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB" or "the Board") Proposed Accounting Standards Update (the Proposed ASU), *Testing for Goodwill Impairment*.

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors worldwide. CFA Institute seeks to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

Goodwill Impairment – Are Markets More Knowledgeable and Efficient Than Management?

The market turmoil of the past few years focused much attention on the accounting for, and impairment of financial instruments. However, as the crisis extended and deepened, the impairment testing of non-financial assets such as goodwill became increasingly important as declining economic prospects signaled that goodwill should be evaluated. As expected, given the downward trend in the economy and financial markets, large write-offs of goodwill occurred during 2009.

Goodwill write-off amounts and the timing should be of considerable interest to investors in terms of the signal they should send regarding the value of the company's intangible assets, the company's future earnings prospects, and an assessment of the amounts paid in prior periods for acquisitions. However, it appears that in practice, the market makes its assessment more quickly and accurately than does management as goodwill write-offs are generally greeted with little market impact because the market

[1] With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 106,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 94,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

price already reflects the goodwill write-off. It appears that management waits until the market recognizes the goodwill impairment before management – which has more information upon which to make the impairment assessment – makes a complete and accurate fundamental valuation of the business to determine if the goodwill is impaired. The notion that management observes its own share price, and only when that price is substantially below book value does management use this as a trigger to impair goodwill seems a backward means of performing the analysis. It suggests that the market knows more than management about the entity's underlying value.

There is substantial empirical evidence that the write-off of goodwill is reflected by the capital markets in the share price of a company prior to when the actual write-off occurs and is announced by the company. A recent study of goodwill impairment by the Financial Executives Research Foundation and Duff & Phelps[3] makes the following observations:

> *Financial and academic studies have analyzed the effect, if any, that goodwill impairment has on stock prices, both before and after goodwill is found to be impaired.*
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> *One study (among others) found that "Impairments are associated with low market returns before the impairment, indicating that market investors anticipate goodwill impairments" (emphasis added). Another study found that "impairments are negatively associated with corporate performance after the impairment" (emphasis added).*
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> *Others remark on the amount of time between probable goodwill impairment and the actual accounting entry indicating that the goodwill is impaired. As one study stated, "...we find that goodwill impairments lag deteriorating operating performance and stock returns by at least two years. Furthermore, the announcements of goodwill impairments elicit little market response. The evidence suggests that goodwill impairment decisions by management are not a timely reflection of the changes in estimated future underlying cash flows but rather a delayed response to the almost complete exhaustion of the goodwill."*

This same study further analyzed the performance of companies that have impaired goodwill relative to the market in general and concluded the following[4]:

> *Companies with goodwill impairments underperform the market both before and after the impairment of goodwill. Most of the underperformance occurs prior to the actual impairment date, indicating that in general, investors are aware of the issues that may lead to a subsequent impairment long before the actual impairment is taken. As time goes on, the performance relative to the market tends to diminish.*

The lack of relevance of current goodwill impairment accounting is not a new phenomenon. Studies of the market impact of goodwill write-offs ten years ago also found that they were a non-event. The recent studies indicate that ASU 350 *Intangibles – Goodwill and Other*, adopted after a prior period of financial market distress, did not fix the problem. As noted in one textbook:

SFAS 142 became effective when the financial markets were suffering from the aftereffects of the technology-media-telecom (TMT) bubble of the late 1990s. Many firms had made acquisitions, recognizing large amounts of goodwill that could not be justified by operating results. As a consequence,

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[3] Financial Executives Research Foundation (FERF) and Duff & Phelps; *2010 Goodwill Impairment Study;* October 2010; Page 21.
[4] Ibid, Page 29.

many companies recognized substantial goodwill impairments in the first quarter of 2002 when they adopted SFAS 142. These noncash impairment charges (which the companies expected the financial markets to ignore) had the following effects:

- *Reduced net assets, increasing return on asset and asset turnover ratios*
- *Reduced stockholders' equity (and book value per share), increasing return on equity and equity turnover ratios but increasing the debt-to-equity ratio.*

Market reaction to these charges was limited. In most cases common share prices already reflected the reduced value of the affected acquisitions. [5]

The notion that the markets are able to recognize when an intangible asset is impaired and reflect it in the stock price, while management of the company cannot do so for its own financial reporting without considerable cost and effort is counterintuitive. The need for this Proposed ASU is based upon the premise that performing a quantitative analysis is too costly, yet the market appears to be able to perform the analysis in a timely manner. As such, adding further qualitative factors that will only further delay the recognition of goodwill impairments is inconsistent with market evidence, which suggests that a quantitative analysis can be efficiently completed by management.

Sufficiency of Qualitative Analysis

The Board's intention in the Proposed ASU is to reduce complexity and costs by allowing an entity to make a qualitative evaluation about the likelihood of whether it is more likely than not that an impairment has occurred. Only if it is "more likely than not" that an impairment has occurred would an entity be required to employ the current two-step process of comparing the fair value of an entity with its carrying amount including goodwill (step one). If the fair value is less than the carrying amount, then the amount of the loss must be measured (step two). For the reasons noted above, we do not agree that a qualitative analysis is sufficient to make a thorough assessment of whether an impairment loss exists and instead believe that it should be supported by a quantitative analysis. We believe that the proposal will allow for increased management discretion and judgment in making an assessment of whether it is more likely than not that an impairment exists. Any change to the requirements that would allow management to postpone the rigor of performing a regular and thorough quantitative analysis will surely lead to an even longer delay in the reporting of impairment losses, to the detriment of investors. We question why, given the importance of impairment, the Board would support a weakening of the financial reporting requirements?

Benefit to Users

CFA Institute questions how the Proposed ASU would benefit users of financial statements and regards it largely as a step backward in the quality of the existing financial reporting requirements. We draw particular attention to Page 3 of the proposed ASU in the section titled: *How Would the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Would They Be an Improvement?* This section curiously makes no reference to whether the Proposed ASU would benefit investors. Also, as noted in the Proposed ASU, the principal reason that the Board has proposed changing the existing financial reporting standard for the evaluation of good will impairment was based on input received from preparers of nonpublic entity financial statements indicating their concerns about the cost and complexity of performing the first step of the two-step goodwill impairment test. While we agree that nonpublic entity concerns must be considered, we believe that this initial concern has extended to

[5] White, Sondhi, Fried, *The Analysis and Use of Financial Statements,* 3rd ed. (John Wiley & Sons, Inc, 2003): 527 – 528.

changing the financial reporting for public entities as well, which we do not believe is an overall improvement.

Reduction in Costs

The Board's stated objective of the proposed ASU is to simplify how an entity is required to test goodwill for impairment and reduce its associated costs. We are not convinced; however, that the changes will necessarily reduce costs. We share the views clearly articulated by others as illustrated in the remarks from another comment letter filed in response to the Proposed ASU[6]:

> *In most situations there will be events or circumstances included in the proposed ASU (or other adverse events or circumstances) that have occurred or exist and the qualitative evaluation of whether goodwill is more likely than not impaired will necessarily be subjective and difficult to audit. In these scenarios, there could be a significant amount of costs incurred in order to document and support the conclusion resulting from this qualitative evaluation as well as to audit that conclusion…. We believe that in certain situations, the rigorous evaluation of the qualitative indicators that will be required along with the appropriate level of documentation could result in costs in excess of those that would have been incurred to perform step one of the goodwill impairment test.* ***This is partially due to the fact that it often takes more time and effort to properly evaluate and document an issue when there is no quantitative analysis to rely on*** [emphasis added]. *If goodwill is more likely than not impaired as a result of this evaluation, which we expect may often occur in the current economic environment, the costs incurred in performing this qualitative evaluation will be incremental to those incurred under existing guidance as entities will still have to perform step one of the goodwill impairment test.*

This response demonstrates that a quantitative analysis is essential to support a qualitative analysis and that costs may not necessarily be reduced but will likely increase. Furthermore, the respondent argues that it will be difficult to audit such qualitative assessments without sufficient quantitative support. As they note, quantitative analysis supports the qualitative factors and vice versa to yield a more thorough assessment.

Although we recognize that costs must be incurred to perform a reasonable assessment of whether impairment exists, we believe that the costs to the entity should not come before the needs of the investors who rely on these valuations to make informed capital allocation decisions.

Disclosures

We do not agree with the Board's conclusion that quantitative disclosures about the assumptions of significant unobservable inputs used in fair value measurements categorized within Level 3 are not required for the fair value measurements related to goodwill after recognition. These initial assumptions are essential to investors' understanding whether the business acquired performed in accordance with those assumptions in subsequent periods. If these assumptions are not included in subsequent periods, investors will not be able to assess whether the goodwill is impaired relative to current market conditions.

We also note that there are no disclosure requirements regarding factors that an entity considers when performing its qualitative analysis even though it is important for investors to understand how the test was performed.

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[6] McGladrey & Pullen; *Comment Letter – File Reference 2011-180;* May 20, 2011; Page 2.

In our comment letter[7] on the Board's Exposure Draft, *Improving Disclosures about Fair Value Measurements*, we stated that we recognize the operational challenges associated with providing disclosure for assets and liabilities measured at fair value on a non-recurring basis in periods subsequent to initial recognition. We believe that an entity should disclose information enabling investors to assess the valuation techniques and inputs used to develop those measurements including sensitivity type disclosures. We understand that there may be operational challenges associated with providing these disclosures given the nature, significance and volume of inputs incorporated into such valuations. However, we do not believe that non-recurring measurements should be excluded from disclosure requirements that provide the range of relevant fair value measures considered in reaching impairment conclusions.

Further, we encourage the Board to require sensitivity disclosures for non-recurring fair value measurements for assets and liabilities initially but not subsequently measured at fair value, such as in business combinations. Requiring such information would provide investors insight into the subjectivity of the estimates used for initial measurement and how future events may impact the valuation of these assets and liabilities.

IFRS Convergence

As noted by the Board, the amendments in the Proposed ASU do not improve convergence with IFRS relating to how an entity tests goodwill for impairment. We believe that a change to the financial reporting standards should comprehensively address differences in the two sets of standards and that the highest quality standard should be chosen. We believe the addition of these qualitative factors prior to the application of quantitative assessment is not an overall improvement and as such we are not supportive of the proposed changes.

Closing Remark

Given that current accounting standards for goodwill impairment do not provide market-relevant information, we urge the Board to reconsider the current proposal and replace it with one that requires prompt consideration of the carrying value of goodwill as soon as the operating results of the acquired entity suggest that the assumptions supporting the original goodwill measurement may no longer be valid.

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If you, other board members or your staff have questions or seek further elaboration of our views, please feel free to contact either Matthew M. Waldron by phone at +1.212.705.1733, or by e-mail at matthew.waldron@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht
Kurt N. Schacht, JD, CFA
Managing Director
Standards & Financial Markets Integrity Division
CFA Institute

/s/ Gerald I. White
Gerald I. White, CFA
Chair
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council

[7] CFA Institute Comment Letter; *Proposed Accounting Standards Update: Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements;* October 28 2009.