DUFF & PHELPS

Goodwill Impairment Step 0 Study

Overview

In September 2011, the FASB issued Accounting Standards Update No. 2011-08 Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment ("ASU 2011-08"), providing public and private companies with the option to first assess qualitative factors to determine whether the fair value of a reporting unit is not "more likely than not" (greater than a 50% likelihood) less than its carrying amount. This is now commonly referred to as "Step 0".

During the last six years Duff & Phelps has performed a joint goodwill impairment study with the Financial Executives Research Foundation, featuring a survey of the members of Financial Executives International (FEI) about their usage of Step 0 in recent years.[1] Given the continued interest in the topic of goodwill impairment by a variety of constituents, and the recent FASB discussions on the most appropriate model for goodwill accounting, we broadened our effort in assessing the use of Step 0 by public companies (the "Step 0 Study").

This Step 0 Study expands upon the FEI surveys by evaluating the disclosures of a random selection of 355 U.S. public companies that carry goodwill on their balance sheets. It is noteworthy that while this study was more expansive than the FEI Surveys and has statistical significance, the indications about the use of Step 0 in both are quite comparable.

We performed the Step 0 Study by analyzing the disclosures of each of the companies in the sample for both 2013 and 2012. This shed light not only on the extent of Step 0 use but also on usage trends. In addition, we sought to identify attributes that may be more prevalent for companies that applied Step 0.

Summary of Conclusions

The evaluation of disclosures of the sample 355 companies in gauging whether or not Step 0 was applied required significant judgment at times. Based on the nature of the disclosures, we classified each company in the sample into one of five categories, independently for 2012 and 2013, and have provided the rationale for making such classification.

Based on this analysis, we observed that the use of Step 0 is relatively broad and has been increasing.

Step 0 Users

33% (2012) → **41%** (2013)

Additionally, we found that companies with a market-to-book ratio of 2 or greater were almost twice as likely to apply Step 0.

In the following pages of this Step 0 Study, we provide further detail on the composition of Step 0 Users and the nature of their disclosures.

1. Visit www.duffandphelps.com\2013U.S.GoodwillImpairmentStudy to view the 2013 U.S. Goodwill Impairment study performed in conjunction with the Financial Executives Research Foundation.

Step 0 Study Approach and Sampling Methodology

2,635 Companies with Goodwill

95% Confidence Level

5% Margin of Error

355 Sample Size

Sampling Methodology

In May 2014, we performed a search in the Standard & Poor's Capital IQ® database for all U.S. incorporated firms traded on all U.S. Exchanges which reported a positive goodwill balance in their latest annual reporting period. The identified firms were narrowed further to those that (1) reported under U.S. GAAP and (2) reported goodwill for both FY 2012 and FY 2013. This resulted in a total population of 2,635 companies.

A standard sample size calculator was used to determine the recommended sample size for a population of 2,635, a confidence level of 95% and a margin of error of 5%. The recommended sample size was 335 companies. We randomly selected a sample of 355 firms (rather than 335) to preserve the sample size and its statistical power, in case some companies needed to be eliminated from the analysis. A few companies were indeed excluded from the sample because of insufficient information for the purposes of our Step 0 Study (e.g., over-the-counter company with no current information). This left 333 companies in the final sample for 2012 and 346 companies for 2013. The same companies were evaluated for both years providing continuity in the analysis.

Classification of Firm Disclosures

The cornerstone in our analysis was par. BC24 of ASU 2011-08, which states:

"...In connection with the annual testing requirement, the Board intends for an entity to make a *positive assertion* about its conclusion reached and the events and circumstances taken into consideration if it determines that the fair value of a reporting unit is not more likely than not less than its carrying amount." [Emphasis added]

Companies making such a positive assertion are unambiguously Step 0 Users. Other companies' disclosures varied greatly in the nature of the discussion and information provided. Based on our analysis of the respective disclosures, we classified each company into one of the following five categories:

Definite User

The company made a positive assertion that Step 0 was applied to some or all of its reporting units and no further goodwill impairment testing was required. We further categorized these companies as "Tier 1" if they made the positive assertion in their most recent fiscal year (2013) and "Tier 2" if they made the assertion in their prior fiscal year (2012). The rationale behind this is that a company may need to establish periodically a quantitative benchmark, or may need to resort occasionally to a quantitative test, none of which take away from the fact that the company has demonstrated that they are a Step 0 User when the circumstances allow for it.

Probable User

The company described Step 0 as an integral part of its impairment testing process. However, the disclosures stopped short of making a positive assertion with regards to the outcome of Step 0.

Possible User

The company described Step 0 in general terms but the discussion did not portray the qualitative assessment as an integral part of the impairment testing process.

Silent

The company did not mention Step 0 in any form in its 10-K for the respective year.

Opt-out User

The company made an explicit statement that it chose not to apply Step 0 for the respective year.

Step 0 Study Results

Observations from the Study

Overall, Step 0 Users (comprised of Definite Users and Probable Users) increased from 33% (2012) to 41% (2013) (Figure 1). Further, it is possible that not all companies are aware of FASB's intent to make a positive assertion about the use of Step 0, since this guidance is included in the Basis for Conclusions of ASU 2011-08 and is not incorporated in the Accounting Standards Codification. It is also possible that there are some Step 0 Users among the Possible and Silent groups, thus the results herein might be on the conservative side.

Definite Users increased from 22% (2012) to 32% (2013). Tier 2 Definite Users for 2013 were 5% and are included in the total of 32% (Figure 2). We did not make a similar Tier 2 adjustment for 2012 as that would have required the analysis of 10-Ks for 2011, which was out of our scope. Any Tier 2 adjustment for 2012 would likely be greater than 0% but less than 5%.

Probable Users for 2012 and 2013 were comparable (11% and 10%, respectively). Possible Users fell by half (from 32% in 2012 to 14% in 2013); the Silent group increased (from 27% in 2012 to 36% in 2013), the Opt-out Users held steady.

Further Insights

We performed additional analysis by following the companies in the sample from 2012 into 2013 and observing whether, and if so how, their Step 0 disclosures changed. While companies in the sample exhibited some "stickiness" with respect to a category year-to-year, Step 0 usage did increase overall:

- Nearly 80% of the Definite Users in 2012 remained such in 2013.
- Just over one-fifth of Probable Users in 2012 became Definite Users in 2013.
- The majority (62%) of Probable Users in 2012 remained in the same category in 2013.
- Of the 2012 Possible Users, 41% remained such in 2013, while 38% became Silent about the use of Step 0.
- Of the Opt-out Users in 2012, 78% remained in the same category in 2013.

Figure 1: Step 0 Users (Definite and Probable Users) increased from 33% to 41% based on our assessment of Form 10-K filings for the two most recent fiscal years of a sample group of companies filing under U.S. GAAP

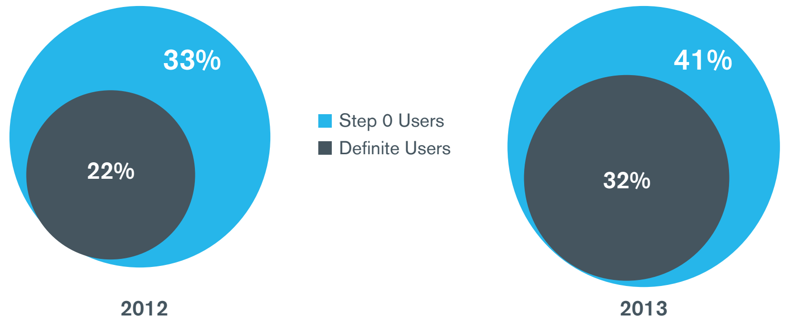


Figure 2: Step 0 Study Summary

	2012		2013		
	Number	Percentage	Number	Percentage	
Definite Users - Tier 1	73	22%	94	27%	A
Definite Users - Tier 2			16	5%	B
Definite Users	73	22%	110	32%	
Probable Users	37	11%	33	10%	C
Step 0 Users	110	**33%**	143	**41%**	
Possible User	106	32%	50	14%	D
Silent	90	27%	126	36%	E
Opt-out User	27	8%	27	8%	F
Total	333	100%	346	100%	G
Excluded from study (insufficient information)	22		9		
Total Study Sample	**355**		**355**		

Notes:
G = A + B + C + D + E + F
Differences due to rounding

Company and Sample Attributes

Sample Quality: Demographics Assessment

Certain demographic attributes of the total population were selected for comparison to those of the Step 0 Study sample to evaluate how representative the sample was of the total population. These attributes included:

- Market Capitalization
- Primary Industry Sector
- Carrying Amount of Goodwill
- Goodwill-to-Total Assets
- Auditor

The companies within the sample displayed a very similar distribution of these attributes relative to those of the total population (Figures 3 to 7).[2] This provides evidence as to the statistical quality of the sample.

Definite Users Attribute Assessment

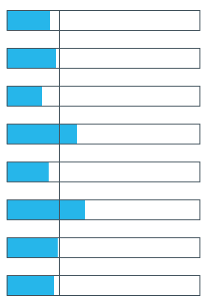
We also evaluated the distribution of the same five attributes for the Definite Users in 2013 (Tier 1, N=94). We did not observe a clear correlation between any of these attributes and the companies' usage of Step 0.

The blue section of the bars in Figures 3 to 7 indicates the proportion that Definite Users represent of the sample for each attribute/category. As the graphics show, the Definite Users constitute, on average, approximately 26% of the sample companies' distribution by market capitalization, industry sector, goodwill balance, goodwill-to-total assets and auditor. In other words, none of the sample attributes provided any insight into or predicted the use of Step 0 by the companies that were considered in our analysis.

Figure 3: Market Capitalization (in U.S.$)

	Total	Sample
50 Million or Less	10%	10%
50 Million to 200 Million	12%	14%
200 Million to 500 Million	14%	14%
500 Million to 1 Billion	12%	14%
1 Billion to 2 Billion	14%	11%
2 Billion to 4 Billion	13%	12%
4 Billion to 10 Billion	12%	13%
10 Billion or More	13%	11%

Definite Users 2013 (% of Sample)

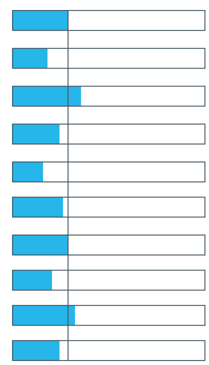


26% Overall

Figure 4: Primary Industry Sector

	Total	Sample
Consumer Discretionary	15%	15%
Consumer Staples	4%	5%
Energy	5%	6%
Financials	20%	20%
Healthcare	11%	9%
Industrials	16%	15%
Information Technology	20%	22%
Materials	5%	4%
Telecommunication Services	2%	3%
Utilities	2%	1%

Definite Users 2013 (% of Sample)

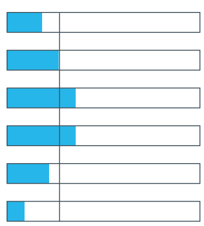


26% Overall

Figure 5: Carrying Amount of Goodwill (in U.S.$)

	Total	Sample
10 Million or Less	23%	24%
10 Million to 100 Million	30%	31%
100 Million to 500 Million	22%	22%
500 Million to 1 Billion	8%	8%
1 Billion to 10 Billion	14%	13%
10 Billion or More	2%	3%

Definite Users 2013 (% of Sample)

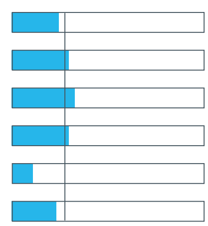


26% Overall

Figure 6: Goodwill-to-Total Assets

	Total	Sample
0% to 10%	51%	52%
10% to 20%	20%	18%
20% to 30%	12%	12%
30% to 40%	8%	9%
40% to 50%	5%	5%
50% or More	4%	4%

Definite Users 2013 (% of Sample)

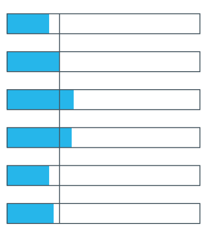


26% Overall

Figure 7: Auditor

	Total	Sample
Deloitte & Touche	15%	14%
Ernst & Young	23%	19%
KPMG	16%	15%
PricewaterhouseCoopers	17%	18%
BDO; Grant Thornton; McGladrey	11%	13%
Other	19%	21%

Definite Users 2013 (% of Sample)

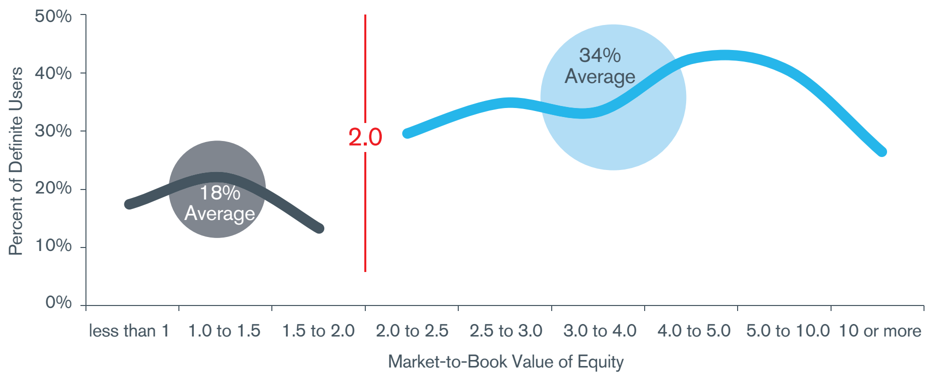


26% Overall

2. Source: Standard & Poor's Capital IQ® database. Based on the latest available annual financial information as of early May 2014. Market capitalization as of 12/31/2013, with the exception of companies filing an IPO during 2014, in which case data is as of 5/8/2014.

Market-to-Book Ratio

Figure 8: Market-to-Book Ratio for Definite Users



Market-to-Book Value of Equity

This ratio was the only attribute that provided some insight into the use of Step 0. This is not surprising, as the market-to-book ratio is an indication of the "cushion" that a company has in place. The "cushion" represents the excess of fair value of the company's capitalization over its book value (or the excess of a reporting unit's fair value over its carrying value).

Since the first step of the ASC 350 test compares the book value of a reporting unit with its fair value, the market-to-book ratio has always been a meaningful indicator to evaluate, albeit on an overall entity level.

Similarly, when considering the use of Step 0, a higher market-to-book ratio for the reporting unit or overall entity, as appropriate, would enter into the analysis as a factor with a positive impact on the qualitative assessment, all else equal.

Companies with a market-to-book ratio greater than 2 were almost twice as likely to be a Definite User of Step 0.

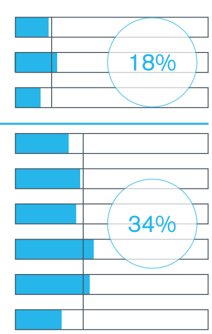
For market-to-book ratios of less than 2, Definite Users represented approximately 18% of the sample companies, on average (Figures 8 and 9).[3]

For market-to-book ratios above 2, Definite Users represented approximately 34% of the sample companies, on average.

Figure 9: Market-to-Book Value of Equity

	Total	Sample
less than 1	19%	18%
1.0 to 1.5	17%	17%
1.5 to 2.0	11%	13%
2.0 to 2.5	10%	9%
2.5 to 3.0	7%	10%
3.0 to 4.0	10%	12%
4.0 to 5.0	6%	6%
5.0 to 10.0	11%	12%
10 or More	8%	3%

Definite Users 2013 (% of Sample)



3. Source: Standard & Poor's Capital IQ® database. Book value of equity as of 12/31/2013. Market capitalization as of 12/31/2013, with the exception of companies filing an IPO during 2014, in which case the data is as of 5/8/2014.

Sample Disclosures

Challenges and Judgments Made

In analyzing the disclosures, we were mindful to distinguish between companies that discussed their assessment of qualitative factors in connection with monitoring for triggering events for goodwill impairment testing vs. the assessment of the same factors considered in the application of Step 0 as part of the annual goodwill impairment test. ASU 2011-08 fully aligns the events and circumstances that a company should consider in either situation.

Sample Disclosures from 10-K Filings

Definite User

"Based on this assessment, the Company concluded that it was more likely than not that the fair value of each of the eight reporting units exceeded its carrying value. As such, it was not necessary to perform a quantitative impairment analysis, and the Company concluded that these reporting units were not impaired as of December 31, 2013 and 2012."

Probable User (elaborate discussion)

"We review goodwill for impairment annually, utilizing the one-step qualitative assessment, in the second fiscal quarter and whenever events or changes in circumstances indicate the carrying value may not be recoverable. In conducting the qualitative assessment, we consider relevant events and circumstances that affect the fair value or carrying amount of the reporting unit. Such events and circumstances could include macroeconomic conditions, industry and market considerations, overall financial performance, entity and reporting unit specific events, cost factors and capital markets pricing. We consider the extent to which each of the adverse events and circumstances identified affect the comparison of the reporting unit's fair value with its carrying amount. We place more weight on the events and circumstances that most affect the reporting unit's fair value or the carrying amount of its net assets. We consider positive and mitigating events and circumstances that may affect its determination of whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. These factors are all considered by management in reaching its conclusion about whether to perform the first step of the impairment test."

Probable User (short discussion)

"The Company first assesses qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in ASC Topic 350."

Possible User

"GAAP permits entities to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, as a basis for determining whether it is necessary to perform the quantitative impairment test of the two-step goodwill impairment test."

Opt-out User

"We elected to bypass performing the qualitative screen and went directly to performing the first step quantitative analysis of the goodwill impairment test."

Silent

"Factors considered that may trigger an impairment review are: significant underperformance relative to expected historical or projected future operating results; significant changes in the manner of use of acquired assets or the strategy for the overall business; significant negative industry or economic trends; and significant decline in market capitalization relative to net book value."

[Note: there was no mention of ASU 2011-08 in the filing of this sample company or any other references to the qualitative assessment option. The factors above were discussed in the context of the ongoing monitoring for triggering events for goodwill impairment testing.]

Conclusion

Our Step 0 Study shows a notable increase in the rate of Step 0 use, derived from a statistically significant sample of U.S. GAAP public filers. In 2013, 41% of the companies in the sample applied Step 0, compared to 33% in 2012. This estimate might be on the conservative side since FASB's intent for a company to make a positive assertion about passing Step 0 is not included in the Accounting Standards Codification, and therefore disclosure language varies greatly.

Practically, companies could more readily take advantage of Step 0 if the reporting unit (or entity) has adequate excess of fair value over carrying value and/or has not been affected by factors that are difficult to evaluate qualitatively, or is not impaired. If one excludes from the sample companies that may be recognizing impairment and therefore cannot apply Step 0, the effective usage rate of the qualitative assessment would be even higher.

With more experience in the application of the qualitative assessment, both amongst preparers and auditors, and an improved economic outlook, Step 0 use may continue to expand. The recent publication of application guidance on the qualitative assessment—Chapter 3 of the AICPA's Accounting & Valuation Guide, *Testing Goodwill for Impairment*, issued in December 2013, addresses the practical application of Step 0—may also contribute to a continued uptick in Step 0 usage.

For more information please visit:
www.duffandphelps.com

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