



Leading / Thinking / Performing

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Technical Director
File Reference No. EITF-100A
FASB
401 Merritt 7
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Dear Sir:

We have read the Proposed Accounting Standards Update entitled “How the Carrying Value of a Reporting Unit Should Be Calculated When Performing Step 1 of the Goodwill Impairment Test” with great interest, and submit our comments in this letter.

Our initial comments are directed at the rationale stated on page 1 for issuing the update. You state that “Some reporting entities calculate the carrying amount of the reporting unit using the equity premise, while others calculate the carrying amount using an enterprise premise.” This is true. However, this does not constitute diversity in practice, so long as the premise of the valuation conclusion is consistent with the premise for calculating the carrying amount. And for reasons discussed below, most valuation practitioners believe the enterprise premise is the more appropriate premise.

You also state that “some entities with zero or negative carrying amounts under the equity premise have concluded that Step 1 of the test is automatically satisfied because the fair value of its reporting unit will generally be greater than zero.” While we have heard this argument made by reporting entities as well as their auditors, we have categorically rejected it. To a valuation professional charged with estimating the fair value of a reporting unit, negative carrying value of the equity can indicate that the reporting unit is experiencing operating difficulties, the book value of the assets (including goodwill, if any) may be overstated, and/or the fair value of the long term debt is less than face. But concluding that Step 1 of the Goodwill Impairment Test is automatically satisfied is erroneous.

In his book entitled “Investment Valuation,” Aswath Damodaran discusses and compares two approaches to valuing a firm: the free cash flows to the equity (“FCFE”), and the free cash flows to the firm (“FCFF”). He argues that “Firms that either have very high leverage or are in the process of changing their leverage are best valued using the FCFF approach. The calculation of FCFE is much more difficult in these cases because of the volatility induced by debt payments, and the value of



equity, which is a small slice of the total value of the firm, is more sensitive to assumptions about growth and risk.” The proposed update would force reporting entities to adopt the more difficult approach in precisely those cases where there is a perceived issue.

Furthermore, Damodaran states that “if the FCFF approach is used to value the equity in a firm, the debt either has to trade at a “fair” price or has to be explicitly valued using updated interest rates that reflect the risk of the debt.” The amendments in the proposed update do not provide guidance on the measurement of the fair value of the reporting unit. We must resort to the limited guidance in Topic 820 on the valuation of liabilities. And if that guidance is followed, we are left with another dilemma: the debt on the balance sheet of a reporting unit is typically stated at its face or principal amount (or original fair value). But the valuation of the equity would consider the current fair value of the debt in cases where the debt is transferable, which could be lower than face, thus increasing the probability of the reporting unit passing Step 1 even though the carrying value of goodwill exceeds its fair value.

To summarize, it is our opinion that the premise upon which this Update is based is flawed. The valuation of the equity of a reporting unit is generally achievable, as is the valuation of the enterprise. The most important consideration is the appropriate comparison called for in Step 1: carrying value of equity with fair value of equity, or carrying value of the enterprise with fair value of the enterprise. Mandating the use of an equity comparison will create a myriad of issues in those situations where there is currently a perceived problem.

The second main provision of the proposed Update is equally troubling. For reporting units with zero or negative carrying amounts, the entity would be required to perform Step 2 of the goodwill impairment test if there are adverse qualitative factors that indicate that it is more likely than not that a goodwill impairment exists. The qualitative factors are the same as those employed to determine whether an interim impairment test must be conducted. Therefore, the quantitative test of Step 1 is replaced by a qualitative test which heretofore was used only to determine whether the quantitative test should be performed. And the replacement of the quantitative test with a qualitative test leaves open the question of what amount needs to be allocated among the underlying assets in Step 2 to determine the implied value of the goodwill. Here again, mandating the use of the equity premise will create additional issues which currently aren’t a practice issue.

Question 1: We do not agree that the equity premise should be the only permissible methodology for Step 1 of the goodwill impairment test. Certain industries, such as banking, insurance, and financial institutions, are valued at the equity level, and should be tested for impairment at the equity level as well. For profitable, growing RUs’, the conclusion of the Step 1 test is generally the same under either approach. The fair value of the enterprise or the equity exceeds the corresponding “carrying amount” of the RU, and there is no indication that goodwill is impaired. However, for RU’s which are experiencing operating difficulties, performing below expectations, or are highly leveraged, testing at



the equity level can skew the results of Step 1 toward passing. Debt is generally carried on the books of an RU at face, depressing the book value of equity. However, if the debt is transferable, with a fair value below face, the fair value of the equity may exceed its carrying value, allowing the otherwise impaired goodwill to pass the test (implied value of goodwill is too high).

Questions 2 and 3: The qualitative factors were appropriate for determining whether the goodwill impairment test should be conducted on an interim basis. They are not an appropriate substitute for the quantitative test of Step 1.

Question 4: A highly leveraged, but marginally profitable, reporting unit performs its Step 1 test on an enterprise basis, and fails. The fair value of the total capital (debt plus equity) is less than the carrying amount of the debt (at face) and equity. If the company performs the test on an equity basis, the fair value of the debt must also be determined. If that is materially lower than face, the fair value of the equity may be greater than the carrying amount, and it would pass Step 1.

Question 5: No comment.

Respectfully submitted,

A handwritten signature in black ink that reads "Gerald J. Mehm".

Gerald J. Mehm
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