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Goodwill Impairment Testing

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The goal of accounting estimates is to provide investors with relevant and timely information about the prospects of a company. However, the goal of relevance comes at potential cost of reliability, because accounting estimates are fundamentally subject to management's judgment, and therefore are also inherently susceptible to management bias and error in making such estimates. This, for example, underlies the Public Companies Accounting Oversight Board's (PCAOB) efforts to improve the auditing of accounting estimates.[1] The U.S. Securities and Exchange Commission (SEC) has made it a priority that SEC registrants ("issuers") provide such sufficient disclosure of how the estimates were derived. For example, in one of its Releases, the SEC states "The Commission issued cautionary advice to companies regarding the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation".[2] It is unclear if an effort to provide greater transparency surrounding the accounting estimates in the financial statements has been successful. This is because it is unclear whether firms provide the levels of estimates disclosure sufficient for an investor to understand how the estimate was derived (due, for example, to high valuation uncertainty) and how sensitive the estimate is to underlying assumptions,[3] and also because it is unclear whether investors pay sufficient attention to such disclosures in the first place.[4] Some researchers go even further and question overall usefulness of accounting estimates for predicting future cash flows.[5]

An example of a potentially impactful future goodwill impairment, in a massive corporation, is the case of Amazon's purchase of Whole Foods. An analyst at CNBC[6] writes "On top of that, the Whole Foods deal stands out because the 70 percent goodwill portion is higher than most other deals involving a physical store brand, Atwater said. Companies that don't own a lot of tangible assets, like software makers, tend to draw higher goodwill, but it's rare for companies in physical retail to get such high goodwill in a deal. For example, when CVS paid $1.9 billion for Target's pharmacy business in 2015, only $916 million, or 48 percent, of the deal accounted for goodwill."

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To study the sensitivity of goodwill impairment reporting, I suggest that this topic may be of interest to researchers from the fields of finance, economics and accounting.

Reference

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