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Accounting for Goodwill Pre&Post SFAS 142 and the Implications for Earnings Management

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Undergraduate Senior Honors Thesis

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Abstract

This thesis explores how impairment charges driven by management assessment have led to the possibility of earnings management under the SFAS 142 standard. The goal of carrying out this research is to help the user understand the implications behind allowing management to judge impairment charges (US GAAP) versus pre SFAS 142 when intangibles such as a goodwill were amortized (currently IFRS).

How has SFAS 142 opened the door for earnings management? If there is evidence to prove this assumption, then what factors drive management's impairment decisions. This information is pertinent to investors when analyzing a potential investment as goodwill can often be a large amount for companies that grow inorganically. Giving management the ability to judge impairment has allowed more leeway in accounting for goodwill, begging the question of how impairment charges can change earnings, sizes of balance sheets and affect stock prices in the market. The user reading this paper will come to understand the accounting for goodwill under SFAS 142 which would allow them to explore at least some metrics that motivate a manager's actions.

By looking at how companies have taken goodwill write downs, analyzing how large they are, and exploring how management have assessed these impairments in the year of the adoption of SFAS 142 by FASB, the goal is to determine the drivers of management's decision in regards to their decision to impair or not impair their goodwill.

I. Introduction & Background

The Financial Accounting Standards Board (FASB) issued the Statement of Financial Accounting Standards (SFAS) 142 to supersede APB 17 and methods for accounting for Goodwill and Intangible Assets. APB 17 stated that intangible assets, specifically goodwill were to be amortized every period (not to exceed forty years) over its "useful" life. This suggests that intangible assets after a certain time period were to lose their value from the normal basis of operations. This is similar to how fixed assets depreciate to the end of their useful lives. The FASB, however revisited APB 17 and felt that it wasn't capturing the true economic effect of the transaction taking place when a company records goodwill. It released SFAS 142 to provide the financial reporting community with a better method for accounting for intangible assets and goodwill. The key highlights to SFAS 142 are:

- SFAS 142 assumes that goodwill and all other intangible assets are long lived indefinite assets that must be tested for impairment at least annually. This is a change from APB 17, which suggests that goodwill and all other intangible assets are finite lived and must be amortized over a predetermined useful life with an arbitrary ceiling of 40 years. SFAS 142 further eliminates this 40-year useful life period restraint.
- APB 17 provided little guidance on goodwill impairments and the criteria in terms of testing for goodwill impairments. SFAS 142 provides guidance on goodwill impairment testing as a two-step process that begins with an estimation of the fair value of the reporting unit. In this two-step process, the first step assesses if the

reporting unit is potentially impaired, the second step measures the amount of goodwill impairment to be taken, if any.

- SFAS 142 also provides guidance for testing other intangible assets at least annually for impairment.
- SFAS 142 requires disclosure of information about goodwill and other intangible assets in the years subsequent to their acquisition that was not previously required. Required disclosures include information about the changes in the carrying amount of goodwill from period to period.

SFAS 142 moves away from the systematic accounting method outlined in APB 17 that is arbitrary but predictable. SFAS 142 requires that management assess goodwill for impairment on an annual basis allowing management to make a judgment regarding the appropriate value of goodwill. Management must compare the fair value of the reporting unit with its carrying value. Generally impairment is necessary if the fair value is below the carrying value of the reporting unit. The issue that arises is that the "fair value" is subject to management's professional judgment, opening the door to earnings management. Management may benefit in certain situations from not taking impairment loss, which include but are not limited to:

- I. Earnings are hovering around a threshold, and taking an impairment loss to goodwill will cause earnings to fall below this threshold with the implication that investors might be disappointed in the earnings results or possibly that

management may not qualify for a bonus in a plan that is based on achieving an earnings target.

- II. Earnings are hovering around a threshold such that taking an impairment loss to goodwill will violate certain debt covenants.
- III. Other key metrics such that taking an impairment loss to goodwill will cause a negative reaction/response from current/future investors.

Jordan and Clark (2004) also cited the possibility that management may be encouraged to record an impairment loss if such an action would not bring about any negative consequences. This is known to be the "Big Bath" theory of earnings management. For example, if earnings are already high, and taking an impairment loss will not bring on the negative consequences outlined above or if earnings are already so low that an additional impairment loss will not bring about significant consequences to the existing situation, then the manager may choose to do so, again without much added negative response from outsiders.

In these regards, SFAS 142 has the potential to increase earnings volatility and creates another opportunity for management to strategically manage earnings, hence allowing them to present financial information that is not necessarily fairly presented and not capturing the underlying economic effects as intended by the FASB and SFAS 142. This paper will examine a sample set of companies that contain a significant amount of goodwill on their balance sheets and investigate conditions under which management has decided to take an impairment. Ultimately, financial reporting is meant to capture the underlying

economic effects of transactions taking place within companies through the use of a systematic accounting system. The application of SFAS 142 may not capture this if, in fact, management is exercising an opportunity to strategically manage earnings.

The FASB and standard setters are constantly conducting research in the field of financial reporting relating to fair value assessments by managers. Fair values of assets and in this case fair values of reporting units are often hard to assess as market participants and different stakeholders hold different opinions on how to value such assets. SFAS 142 gave managers the responsibility and the ability to assess the fair value of a reporting unit based on an impairment test. However, the assumptions that feed into the impairment test are subject to management intent and discretion. Management has the leeway to decide a fair value amount (subject to auditor review) that may not necessarily reflect the appropriate fair and economic value of a reporting unit but rather can identify a value that aligns more with the strategic goals of the firm. The value identified can more closely align with the incentives that a manager may receive if they achieve a certain result. Managers can manipulate earnings by choosing to impair goodwill or deferring impairment based on which-ever decision is more beneficial to the firm. If managers act with this intent, SFAS 142 has failed to accomplish the FASB's goal to develop accounting standards that allow firms to account for transactions fairly so that by following these standards firms are capturing the underlying economic reality of these transactions.

Furthermore, many in the academic community have argued against SFAS 142 in regards to the sporadic impairments that follow such a random pattern leading to earnings

volatility. In APB 17, goodwill was amortized and followed a pattern that was predictable and spread out over a useful life. Sloan and Li (2011) conducted a study in which they looked at the patterns of firms applying SFAS 142 and what the implications were to valuation of goodwill. In their paper, they concluded that SFAS 142 leads to untimely impairments, inflated goodwill balances and increased earnings volatility. This arises because of management discretion in assessing the fair value of goodwill. Sloan and Li (2011) also concluded that with SFAS 142, accounting for goodwill fails to improve the financial statement user's ability to assess the probability of future cash flows and values of goodwill, a goal the FASB intended in SFAS 142. By presenting managers with another opportunity to manage earnings, users of financial statement are not necessarily being presented with statements that reflect the underlying economic reality behind the firm and its operations. Sloan and Li (2011) argue that strategic decisions can supersede accounting decisions that reflect the economic reality of the transaction leading to mispricing of firms in the market.

II: Case Analysis of AOL Time Warner, Inc.

When SFAS 142 was issued, the FASB gave companies a one-time opportunity to recognize an impairment charge as "due to accounting change" which affects net income below the line. This also suggests that there is an incentive (as we will see in the following case example) to impair goodwill to the appropriate fair value without having negative reactions from the capital markets and investors. Investors may treat a charge recognized as "due to accounting change" as not relating to the operations of the company and may write it off in their own analysis of the company. The AOL Time Warner merger provides an interesting perspective into the one-time opportunity to have an impairment recognized as below the line following the adoption of SFAS 142.

In the year following the AOL Time Warner merger, the company, upon the adoption of SFAS 142 in the first quarter of 2002, took a goodwill write down of \$54 billion to the goodwill that resulted from the AOL Time Warner Merger. The market perceives goodwill as the excess or premium that is paid to acquire a company. Generally, in order for acquisitions to occur, a premium is paid over the book and/or market value of the target company. Pre-SFAS 142, companies could have placed less emphasis on the accounting for goodwill and more on bidding for companies, even if this meant exorbitant prices. The reason for this is that under APB 17, goodwill impairments were rare as goodwill was amortized. This meant that companies could focus less on assessing reporting units for annual impairment and have the expectation of what amortization schedules would look like from their acquisitions. SFAS 142 significantly changed that in the sense that if

companies were to pay exorbitant prices for the company's they are acquiring, and it isn't a "fair value" to pay for the company, they may likely have to take large impairments in subsequent years. Like in the case of AOL Time Warner, a \$54 billion impairment to goodwill created a lot of press coverage questioning the merger deal in the first place. However, AOL Time Warner was able to strategically manage the impairment and accounted for it as a "cumulative effect of an accounting change." This was an option given to managers of companies as a way to account for goodwill impairment following the adoption of SFAS 142.

Beatty and Weber (2005) mentioned in their research that companies may be inclined to take impairments following the pronouncement because the market may discount this as simply the one-time effect of an accounting change as oppose to a write-off that signals an actual decrease in value of the acquired company. This is stating that if AOL Time Warner were to take this impairment in subsequent years such that they can no longer recognize it as a "cumulative effect on an accounting change," then it would simply appear as an impairment charge on the income statement. The market could perceive this differently as a true decrease in value.

SFAS 142 requires companies to test for impairment, but it does not require much disclosure for what led the company to impair goodwill. Often times, it simply states something along the lines of "due to the valuation services performed by an independent appraiser or as a result of internal analyses we conclude that we must take an impairment to goodwill." This leads to information asymmetry between financial statement users and the company, ultimately resulting in a lack of understanding of how the decrease in value

came to be. In this sense, managers can easily take an impairment charge in the year of adoption with explaining to the market what led to the decision to do so.

III. Related Research

In this paper the results from the research conducted by Beatty and Weber (2005) will be partially replicated. Beatty and Weber believed that in the year of SFAS 142 adoption, certain variables caused managers to take impairments to goodwill in the year of adoption and recognize it as an expense due to accounting change. In this sense, stakeholders may interpret the impairment charges taken to not be a result of operations but rather one of a mandatory accounting pronouncement. The FASB mandated that in the year of adoption, all goodwill impairments are to be recognized below the line as a result of implementing SFAS 142. Managers can perceive this as a one-time opportunity to impair their goodwill without significant repercussions as a mandatory accounting change effect, which is consider to be below the bottom line where as future impairments are considered in other income. Other managers however, may be able to justify the fact that they may never need to take the impairment to goodwill as they waive the benefit of treating any possible impairments below the line due to a mandatory accounting change.

In this paper, a subset of the variables identified by Beatty and Weber (2005) will be used to test what drives and motivates a manager to impair goodwill on the books. Beatty and Weber argue that management intent is a factor that drives accounting action if there are outsiders judging the outcome to such an action. One such example that they used was

debt covenants on the debt contracts that certain firms hold. They argue that if a firm's capital structure contains a greater amount of debt where certain covenants depend on the debt to equity ratio metric, that a reduction in net income via an impairment would further reduce equity making the debt to equity ratio even worse leading management to perhaps avoid taking the impairment. From this we can reasonably predict that a manager of a company with a large debt to equity ratio is less likely to impair goodwill thus preventing the triggering of the debt covenants.

IV. Hypothesis Development

After reading related research and accounting literature, the following hypotheses are formulated regarding the variables that affect whether a company decides to take goodwill impairment in the year of adoption of SFAS 142 by FASB.

Hypothesis I: Debt to Asset Ratio

Companies with high debt to asset ratios would be less likely to take goodwill impairment charges. Companies whose capital structure is characterized by high levels of debt exhibit the possibility that any hit to earnings will trigger debt covenants. Triggering multiple debt covenants can disrupt a company's operations and capital structure causing them to look for other ways to refinance their activities. Managers are more likely to waive the impairment to goodwill to subsequent years or never choose to take the impairments to avoid triggering these debt covenants.

Hypothesis II: Net Income

Companies with lower amounts of net income will be less likely to take goodwill impairment charges. The capital markets, the investment community and the stakeholders of companies keep a close eye on the net income figure as a way to assess performance by management. If a company is publicly or privately traded, capital market constituents focus heavily on earnings and earnings per share figures as an indication of how efficient the company's operating activities are being converted to profitability. Stakeholders assess management's performance using the net income figure as a general and overall gauge to see if management has met its duties to all stakeholders. Therefore managers place a lot of emphasis on this figure and ensuring that they are, at a minimum, meeting earnings expectations if not actually beating them.

Managers considering taking goodwill impairment will look to the pre-reported earnings and assess what the after-effects of a goodwill impairment will be on the net income figure. If the net income figure is low to begin with because of poor company operations, managers are less likely to impair their goodwill as to further decrease their earnings figure. Jahmani, Dowling and Torres (2010) commented in their paper on the likelihood that managers will actually take an impairment to goodwill. They concluded in their findings that if a firm had consecutive losses for three years, they are less likely to impair their goodwill. This suggests that managers would want prevent a situation where earnings take any further hits. In terms of accounting for goodwill, they would be reluctant to take any impairment that would further decrease net income figure. With the introduction of SFAS 142 managers are able to accomplish this as management discretion

is a key difference in that managers can now assess their goodwill for impairment, giving the rise in opportunity to earnings management.

It is also important to note that the Big Bath theory of earnings management takes the opposite view from that of Jahmani, Dowling and Torres (2010) and claims if a company is already exhibiting a net loss, managers may be inclined to take an impairment to goodwill in the current year as to prevent taking impairment and losses in future periods. Jordan and Clark (2004) argued that companies are more inclined to have negative results all in one year if given the opportunity to do so as to prevent losses from future periods. Managers who choose to take an impairment to goodwill in the current year of a net loss will be padding earnings in subsequent periods making results appear more positive than they actually may be in reality. Jordan and Clark (2004) claimed that if companies are already exhibiting low earnings and negative results, the added penalty to taking a large write-off to goodwill is marginal. The burden to impair goodwill will be removed from future periods and this will allow firms to expect better earnings in future periods.

Hypothesis III: Total Assets

Smaller companies will be less likely to take goodwill impairment charges. The argument is that a larger firm, holding all else constant would presumably have more resources than smaller firms that would allow them to absorb impairments to their goodwill. Bigger firms are more "prepared" to take such write-offs to goodwill because of a

greater amount of assets on their books, the impact of an impairment to goodwill is unlikely to impact them in the same way as a firm with a significantly fewer assets.

Hypothesis IV: Return on Assets

Companies with a lower Return on Assets (ROA) metric will be less likely to take goodwill impairment charges. ROA as calculated by net income divided by total assets takes on similar logic from the net income discussion above. ROA is another key metric that the capital markets and stakeholders use in order to assess the performance of a company. Firms that have a low ROA will be less likely to take goodwill impairments and further drive down the ROA metric. With SFAS 142, managers are able to strategically take goodwill impairments to preserve metrics like ROA specifically and may not necessarily reflect the underlying economic reality of the events taking place in operations. Managers will manage earnings in such a way that if ROA is extremely low in one year they will defer taking a goodwill impairment to subsequent years, whereas if managers are more likely to take an impairment to goodwill in the current year if ROA is on the higher end and they can "afford" to take a hit to ROA without penalty and negative feedback from their stakeholders.

V: Research Design

The design will test the relationship between the hypothesized variables and the decision to impair or not. The following model is used:

$$\text{Impair} = \beta_0 + (\beta_1 \times \text{Debt}) + (\beta_2 \times \text{Net Income}) + (\beta_3 \times \text{Total Assets}) + (\beta_4 \times \text{Return on Assets})$$

Where:

Impair = "1" if the decision is to impair and 0 otherwise

Debt = Ratio of debt to assets

Net Income = Reported net income during the year

Total Assets = Total value of assets reported per book

Return on Assets = Net income divided by total assets

The model will be tested in the initial year of adoption which is 2001.

Sample Set Selection

The adoption of the standard allowed firms to adopt in 2001 and therefore the sample used to test the hypotheses came from this year. This resulted in 1,470 firms that reported goodwill and of this, 108 firms chose to impair goodwill. To further refine the sample, firms were dropped from the sample if they had insignificant amounts of goodwill relative to total assets. Firms were eliminated if the percentage of goodwill to assets was less than or equal to 10%. This reduced the sample to 634. This sample likely contains a subset of firms for which impairment of goodwill was clearly not a possibility. This would be the case if goodwill was less than the difference between the market value and the book value of assets (the key test for impairment). While the decision to impair is based on the subunits

of the firm to which goodwill is allocated, this overall assessment of the firm serves as a proxy for what may be the case at the subunit level. This refinement in the sample yielded a total sample of 265.

Goodwill Data Sample Set Selection	
Firms from Compustat with Goodwill from FY 2001	1,470
Less: Firms from FY 2001 where Goodwill as a % of Total Assets was 10% or less	836
Firms from FY 2001 where there is a <i>significant</i> amount of Goodwill on their balance sheet	634
Less: Firms where Goodwill is less than the difference between the Market value and the Book value of assets	369
Final Sample Set Size	265

Regression Results

The tablet below presents the result of the regression.

<i>Variables</i>	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>
Intercept	0.114080679	0.026841605	4.250143737	2.98007E-05
X1 - Debt to Assets	-0.227414328	0.09268777	-2.453552704	0.014802067
X2 - Net Income	-0.000245397	0.000107727	-2.277954319	0.023541237
X3 - Total Assets	6.90979E-06	6.52014E-06	1.059761069	0.290236812
X4 - Return on Assets	-0.211747893	0.027994926	-7.563795535	6.76083E-13

Note that all of the independent variables are significant at the P=0.05 or better level with the exception of total assets. Note further that the marginal effects of Debt to Assets and Return on Assets are larger given the size of the coefficients than Net Income and that they are both significant at the P=0.01 or better level. This suggests that these two metrics are larger and more significant drivers in the decision to impair.

From the above results we can extrapolate that a firm's debt to assets ratio and return on assets ratio significantly influences a manager's decision on whether to take an

impairment in the current year or defer impairment to subsequent years. The coefficient returned from the regression analysis for the debt to assets variable suggests that if a firm has a higher debt to assets ratio, they are less likely to impair which is consistent with our expectation. This is in line with common theory that a firm is less likely to take an impairment loss to goodwill and risk triggering debt covenants. Firms that have high debt to asset ratios are the firms who carry higher amounts of debt on their books and naturally would have to be more careful with operating results as to not disrupt the capital structure of the firm. If the firm were to take an impairment that crosses the threshold of a debt covenant, then immediate repayment of the debt is likely to be required by the firm's creditor. The coefficient suggests that managers will be less likely to take an impairment if their firm has high levels of debt and would like either defer impairment to future periods or never have to take the impairment to goodwill. SFAS 142 gives the manager leeway to choose whether or not to impair as to protect the firm from violating its debt covenants.

The coefficient results from the ROA variable suggests that for a firm with a higher return on assets ratio, they are less likely to impair their goodwill. This is a departure from the hypothesis stated above that a firm with lower ROA are less likely to impair their goodwill but is somewhat consistent with the Big Bath theory in that low ROAs make it more likely for firms to impair. ROA measures how effectively a firm is utilizing its assets to generate profits. A firm with a high ROA is using its assets effectively to generate substantial profits. If a ROA metric results in a less likely chance of impairment to goodwill, this can arise because managers who are facing good results in a given year are less prone to decrease those results. A high ROA is generally perceived well by the capital markets and

stakeholders, and on a good year taking an impairment loss may contain an added penalty such that the capital markets and the stakeholders react negatively to the firm's decision. Managers are likely to keep the favorable results this year and assess the fair value of their goodwill on their books to be higher than the true fair value.

From the regression analysis, there is evidence that managers base their decision for goodwill impairment under SFAS 142 on certain factors of their firm. This is a departure from the intent of FASB to issue and set standards such that managers are presenting financial information that captures economic reality. The analysis conducted suggests that managers are making decisions regarding their firm's goodwill strategically to manage earnings in any given year as oppose to making decisions that reflect the underlying reality of the transactions taking place. The decisions of management are now less predictable and more volatile than the preceding APB 17 standard that allowed for a systematic amortization of goodwill over a useful life. Amortization of goodwill under APB 17 was very systematic similar to the calculations of depreciation for fixed assets. Users of the financial statement can reasonably predict cash flows under APB 17 they can easily predict what future amortization amounts are based on looking at the goodwill footnote calculations. By adopting SFAS 142, the motivation behind accounting for goodwill is not necessarily in line with providing users greater probability of predicting a firm's current and future cash flows. FASB also states that from an accounting theory perspective, goodwill under APB 17 was amortized over a useful life initially to signal that the excess of fair value from an acquisition is being "used up" in operations as operating years passed. Goodwill was being amortized to show that a firm that completed an acquisition and

expected synergies was realizing them as time passes. This would mean that in future years there was no need to state that there is an excess in fair value on the books of the acquirer if all the benefits have been realized. SFAS 142 takes a different view and states that if an acquirer recognizes goodwill, that value stays on the books until the a fair value assessment tests shows that the acquired company is no longer as valuable as once perceived during the acquisition. Sloan and Li (2011) mentioned that this lag in recognizing the value from an acquisition disrupts the pricing of the acquirer in the market arising from an unpredictability in the accounting for goodwill. In essence this gives management the leeway to use the goodwill asset and the goodwill impairment as an avenue to manage their earnings to show the results that can strategically benefit their firm. The decision to impair or not hinges on the variables mentioned above.

VI: Conclusion

This paper and related research has shown that at least on some level the drivers for the decision to impair goodwill is strategic and evidence of earnings managements following the adoption of SFAS 142. If this is the case, SFAS 142 has failed to achieve the FASB's goal of capturing underlying economic reality. Managers tend to make decisions for their business that sometimes can present a better situation than what it *actually* should be. Using companies in the sample and looking at AOL Time Warner's 10-K as a specific example, comments and footnotes relating to goodwill generally outline that the company tests goodwill on the books for impairment annually under SFAS 142. Companies hire independent valuation firms and conduct internal analyses to determine if the value of the reporting unit has been impaired, but they are not required to disclose additional detail. This creates a disconnect between what the SFAS 142 wants to accomplish and what it in fact does accomplish in reality. As noted in the study conducted above, managers assess metrics such as their firm's debt to assets ratio and return on assets to gauge whether it would make business sense (as opposed to accounting sense) to take an impairment. This begs the question, are managers assessing the fair value consistent with the guidelines on fair value put forth by the FASB. In closing, there is evidence that suggests that implementing SFAS 142 gives managers an opportunity to strategically manage earnings and that in having managers run their own impairment test, unverifiable estimates produced by managers will exist. Financial statement users are therefore in a lesser position to assess the decision taken by the manager. The unpredictability and irregularity

of these impairments under SFAS 142 ultimately lead to greater earnings volatility which may disrupt the decisions carried out by the stakeholders and investment community.

VII: Current Developments

In the fall of 2011, the FASB amended SFAS 142 by introducing Step "0" in the impairment assessment process. Under the new update to SFAS 142, companies may now elect to perform Step "0" and based on the results they may not have to actually perform the whole two-step impairment process. Step "0" states that managers need to ask the question, "is the fair value of a reporting unit *more likely than not*, (basing it off of a 50% threshold) less than the carrying amount?" If the answer is yes and it is more likely than not that the fair value of the reporting unit is less than the carrying amount, then the manager proceeds to carry out the two-step impairment test as stated by SFAS 142. If the answer is no and it is not more likely than not that the fair value of the reporting unit is less than the carrying amount, the manager is not required to perform the two-step impairment test. In the second scenario, the manager only needs to comment on the assessment in the financial statement footnotes. The FASB issued this update to emphasize the qualitative factors that drive the fair value and impairment of goodwill. Smaller companies proposed the idea that under SFAS 142, it became costly to carry out the two-step impairment test because of costs associated with identifying fair value. Smaller companies contended that it did not make business sense to incur these costs when they can reasonably tell that there was no impairment to goodwill. The FASB agreed with this issue, and as a result issued the update to SFAS 142 to alleviate this issue. The FASB also offered guidance to companies in

the update on what the key items (non-exhaustive list) are that factors into the determining the fair value of a reporting unit. This is also meant to alleviate the costs associated with performing impairment testing.

This addition gives the manager another opportunity for earnings management and divergence from reporting the underlying reality of the reporting unit. The extension to SFAS 142 has now made it easier in the sense that managers can simply write-off the fact that an impairment must take place because they can internally justify that the reporting unit in question does not pass the Step "0" test. The FASB claims that they are giving rise to focusing on the qualitative aspects rather than the quantitative aspects that led to a decision of impairment. The FASB contends that a manager should consider the following factors when assessing the likelihood that the fair value of the reporting unit is greater or less than the carrying value: macroeconomic conditions such as fluctuations in the credit markets, industry and market considerations such as decrease in business profitability in the sector, cost factors such as materials and labor, financial performance of the reporting unit, other changes in the reporting unit that could affect key areas to the business, a sustained decreased in the share price of the reporting unit. The FASB is placing the responsibility of determining fair value on the manager's shoulders from a qualitative lens. Through this, the FASB wants to achieve the balance between cost efficiency and still capturing the economic reality behind a reporting unit.

VIII: Proposal for Future Research and Caveats

Given that the research outlined in this paper only modeled decisions following the adoption of SFAS 142, specifically looking at the decision to impair and recognize as below the line accounting treatment, a similar regression model can be ran on subsequent years similar to the methods used in the Beatty and Weber (2005) paper and this paper. It is important to note that the regression used in this paper modeled out the decision to impair focusing on a year where managers had a one-time opportunity to recognize these impairments below the line, but can still be useful in predicting impairments in the future even when the one-time opportunity does not exist. Jahmani, Dowling and Torres (2010) concluded that in using a sample set of companies from the years 2003 to 2005, they found certain variables affected a manager's decision to impair. The variables they used were primarily related to net income.

Another caveat is the time frame of the research presented in this paper. A longer time frame would allow more refined research relating to the following areas:

1. Compiling data reported in annual filings relating to the goodwill footnote and analyzing how companies describe the process and methods they used that led them to their impairment decision.
2. Compile companies into different industry sectors, and conclude if certain industries are more prone to impairment. The research firm, Duff and Phelps compiled a research report that outlined goodwill impairments across different industry

sectors. This suggests that certain industry, due to the nature of their industry operations may be more prone to take impairments to goodwill.

3. Analyze compensation structures of firms and assess if executive compensation is measured based on certain factors where an impairment to goodwill be negatively affect them. Beatty and Weber (2005) compiled the compensation data for their sample set, and propose the argument that firms where a executive compensation and bonuses are dependent on the earnings of a firm, managers may be less prone to take goodwill impairments as to raise the bonuses they receive.

As mentioned above, the FASB has updated SFAS 142 to include Step "0" giving managers the possibility to skip the two-step impairment test outlined in SFAS 142 if they deemed that it is not more than likely that the fair value of the reporting unit is greater than the carrying value of the reporting unit. Future research can be conducted once firms start implementing and using Step "0" in their accounting for goodwill to track how many firms have indeed used the Step "0" update, and of those firms what variables affected the decision to do so. In addition, of the firms who chose to impair their goodwill, how many conducted the Step "0" analysis such that the results of the analysis signaled the managers to move onto the two-step impairment test because there is a "more than likely chance" that goodwill is impaired.

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Source 2: Pellegrini, Frank. "What AOL Time Warner's \$54 Billion Loss Means." *Time*. Time, 25 Apr. 2002. Web. 06 May 2012. <<http://www.time.com/time/business/article/0,8599,233436,00.html>>.

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