

Provider Post

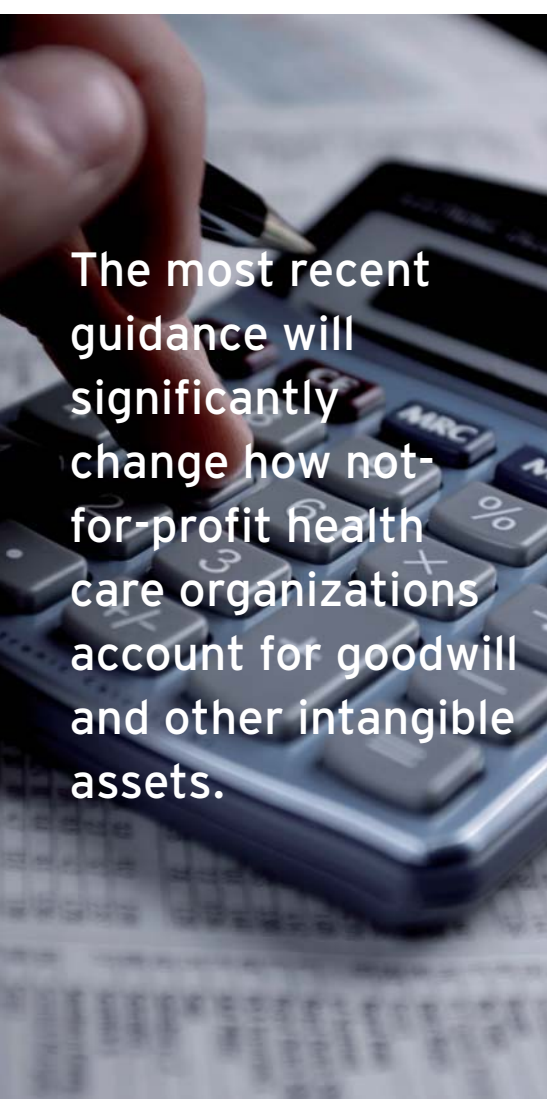
News and analysis of current issues affecting health care providers

Goodwill impairment testing

Meeting the new requirements for not-for-profit health care organizations

Newly effective accounting guidance from the Financial Accounting Standards Board (FASB) will have a significant impact on accounting and reporting requirements for not-for-profit health care organizations. The new standard, Statement 164, *Not-for-profit Entities: Mergers and Acquisitions* (Codified in ASC 958, *Not-for-profit Entities*), establishes accounting principles and reporting requirements for combinations of not-for-profit entities. It also amends Statement 142, *Goodwill and Other Intangible Assets* (codified in ASC 350, *Intangibles: Goodwill and Other*) to make it fully applicable to not-for-profit organizations. Table 1 on the next page summarizes the accounting guidance impacting goodwill testing, along with additional Ernst & Young resources that provide further insights.

The most recent guidance, effective for fiscal years starting on or after 15 December 2009, will significantly change how not-for-profit health care organizations account for goodwill and other intangible assets. Although previously amortized as a wasting asset, goodwill and other intangible assets that have indefinite lives are no longer amortized. Instead, they are tested at least annually for impairment, including a transitional impairment evaluation at the beginning of the year in which the new guidance is adopted. This *Provider Post* contains an overview of the new goodwill impairment requirements and suggested action steps for not-for-profit health care organizations.



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Table 1. Summary of guidance impacting goodwill testing by not-for-profit health care entities

Precodification standard	Accounting Standards Codification reference	What the standard did	Ernst & Young publications offering additional information*
APB Opinion No. 17	Not codified	Provided guidance on accounting for goodwill by not-for-profit health care organizations due to delayed effective date of Statement 142.	
FASB Statement of Financial Accounting Standards No. 131, <i>Disclosures about Segments of an Enterprise and Related Information</i> (Statement 131)	Primarily ASC 280, <i>Segment Reporting</i>	Established standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports issued to shareholders. Statement 142 referred to Statement 131 to provide guidance for determining reportable units, the level at which goodwill impairment testing is performed.	Financial Reporting Developments publication, <i>Segment reporting</i>
FASB Statement of Financial Accounting Standards No. 142, <i>Goodwill and Other Intangible Assets</i> (Statement 142)	ASC 350, <i>Intangibles – Goodwill and Other</i>	Superseded Opinion 17 and required a new goodwill impairment testing model, with a delayed effective date for not-for-profit health care organizations.	Financial Reporting Developments publication, <i>Intangibles – goodwill and other</i> , and Technical Lines No. 2009-07 and No. 2009-09, <i>Fair value considerations – Statement 157</i>
FASB Statement of Financial Accounting Standards No. 157, <i>Fair Value Measurements</i> (Statement 157)	Topic 820, <i>Fair Value Measurements and Disclosures</i>	Defined fair value, established a framework for measuring fair value in generally accepted accounting principles, and expanded disclosures about fair value measurements. The measurements required by Statements 164 and 142 are predominately at fair value, as defined by Statement 157.	Financial Reporting Developments publication, <i>Fair value measurements – Statement 157</i>
FASB Statement of Financial Accounting Standards No. 164, <i>Not-for-Profit Entities: Mergers and Acquisitions</i> (Statement 164)	Primarily the Business Combinations Subtopics of the Health Care Entities (958-305) and Not-for-Profit Entities Industry (954-305)Topics	Provided guidance on the accounting for mergers and acquisitions by not-for-profit organizations, including the recognition and subsequent accounting for goodwill resulting from an acquisition.	Hot Topic No. 2009-17, <i>FASB issues Statement 164 on business combinations by not-for-profit entities.</i>

*These publications may be obtained from Accounting Link through Assurance at www.ey.com or from any member of your Ernst & Young service team



Goodwill impairment testing

The new accounting guidance requires not-for-profit organizations to test goodwill for impairment at the beginning of the year of adoption and at least once annually. “Impairment” occurs when the reporting unit implied fair value of goodwill exceeds the carrying amount. “Reporting unit” and “implied fair value” are new concepts for not-for-profit organizations. These concepts and the major changes in testing for goodwill impairment are summarized below.

A two-step process

Under previous guidance, organizations were required to test intangible assets, including goodwill, for impairment only under certain circumstances. With the new guidance, not-for-profit organizations will need to perform the goodwill impairment test at least once a year and at the beginning of the year of adoption under a two-step process:

- ▶ **Step 1: determine whether goodwill is potentially impaired.**
The first step compares the fair value of a reporting unit with its carrying amount. This step will produce one of two results:
 - ▶ The fair value of a reporting unit exceeds its carrying amount. If so, goodwill is not impaired and no further work is required.
 - ▶ The carrying amount of the reporting unit exceeds its fair value. If so, goodwill of the reporting unit is potentially impaired, and step 2 must be performed.
- ▶ **Step 2: measure the amount of impairment.** The second step compares the implied fair value of the reporting unit goodwill to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized equal to the difference.

Because the impairment model uses the comparison of the fair value and carrying value of the reporting unit as the initial

measure of potential impairment, the guidance requires that if an impairment test of goodwill and any other asset is required at the same time, impairment tests of all other assets (e.g., long-lived assets) should be completed and reflected in the carrying value of the reporting unit before completing the goodwill impairment test.

Identification of reporting units

Since the new guidance requires testing at the reporting unit level, identifying all reporting units is a critical step. Depending on criteria described below, the reporting unit is either an “operating segment” or one level below the operating segment, a “component.” The operating segment is the highest level within the organization that can be a reporting unit (i.e., the ceiling), while the component level is the lowest level within the organization that can be a reporting unit (i.e., the floor). To determine whether the reporting unit should be identified at the operating segment or the component level, the following guidance is applied:

- ▶ A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component.
- ▶ However, two or more components within the same operating segment should be aggregated and deemed a single reporting unit if the components have similar economic characteristics.
- ▶ An operating segment should be deemed to be a reporting unit if all of its components have similar economic characteristics, if none of its components is a reporting unit, or if it is comprised of only a single component.

Shown on page 6 is an example of how the concepts described above would be applied by a not-for-profit health care organization.

The new accounting guidance requires not-for-profit organizations to test goodwill for impairment at the beginning of the year of adoption and at least once annually.



Fair value measurements of a reporting unit

In step 1 of the goodwill impairment test, the fair value of a reporting unit will need to be determined in accordance with the guidance for fair value measurements. If step 2 of the goodwill impairment test is required, determining the implied fair value of goodwill requires all of the assets and liabilities of the reporting unit to be measured at fair value (i.e., a “hypothetical” purchase price allocation is performed as if the reporting unit had been acquired). In this hypothetical allocation, fair values are assigned to all of the reporting unit’s assets and liabilities. Any remaining unassigned fair value represents the implied fair value of goodwill for the reporting unit.

While this process may be costly and time consuming, fair value is assigned to the reporting unit’s assets

and liabilities only for the purpose of measuring goodwill impairment and should not result in a change in the amount recorded for these assets and liabilities. Finally, the implied fair value of goodwill is compared to the carrying amount of goodwill. If the implied fair value of goodwill is less than the carrying amount, an impairment loss is recognized for the difference (i.e., write down the carrying amount of goodwill to the implied fair value of goodwill). Subsequent reversal of previously impaired goodwill is prohibited.

Determining the fair value, as defined by the accounting guidance, of reporting units and related implied fair value of goodwill is a complex process that usually includes valuation specialists. The valuation specialists may use one or a combination of valuation techniques to determine fair value, including the cost approach, market approach or income

approach, which usually incorporates a complex discounted cash flow analysis. These valuation techniques often require significant data, including projections of future cash flows, and other input from the organization. Be prepared to dedicate resources to assist the valuation specialists.

Frequency of goodwill impairment tests

In addition to the transitional impairment test requirement, under the new guidance, goodwill of each reporting unit must be tested at least once a year - or more often if events or changes in circumstances occur that would more likely than not reduce the fair value of the reporting unit below its carrying amount. The timing of the annual impairment test does not have to be at the end of each fiscal year. The fair value measurement required in step 1 of the impairment test can be performed at any time during the



year as long as that measurement date is used consistently going forward. Further, an entity can choose to assign different measurement dates to different reporting units based on such factors as the seasonality of the business, the dates that it will be easiest to obtain the required fair values, and the need to spread out the workload if determinations are to be performed internally.

We encourage organizations to adopt an annual impairment test date at the beginning of a fiscal quarter, preferably the fourth quarter. With this approach, organizations will have the appropriate carrying values available as of the last day of the prior fiscal quarter and will have the full quarter to assess whether they have a potential impairment (step 1) and complete the measurement (step 2) if required. Further, this approach would alleviate concerns about whether indicators exist

in later quarters of the fiscal year, which could occur if the impairment test were performed earlier in the year.

Carrying forward of reporting unit fair value

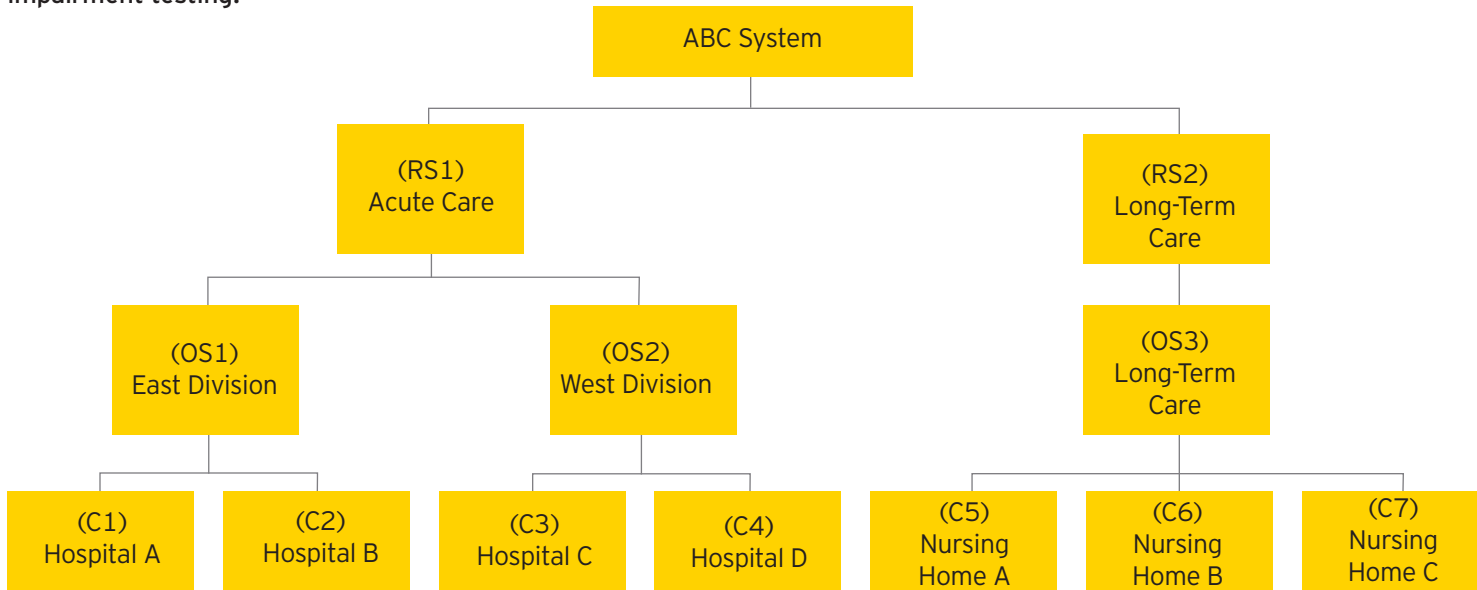
The annual impairment test does not necessarily require a new determination of the fair value of each reporting unit every year. Companies may carry forward a detailed determination of the fair value of a reporting unit from year to year if all of the following criteria are met:

- ▶ The assets and liabilities that comprise the reporting unit have not changed significantly since the most recent fair value determination (e.g., there has not been a recent acquisition or reorganization of the organization's reporting structure).

- ▶ The most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin. The new guidance does not specify what is meant by "substantial margin." We believe that "substantial margin" should be considered in light of the volatility of valuations in the health care industry.
- ▶ Based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, it is remote that a current fair value determination would be less than the current carrying amount of the reporting unit (e.g., there have been no adverse changes in the key assumptions or variables used in the previous fair value computation).

Identifying reporting units: an example

The following example illustrates how a not-for-profit health care system would identify reporting units for goodwill impairment testing.



RS = The reportable segments determined under segment reporting guidance. Although not-for-profit entities are not within the scope of segment reporting guidance, the goodwill impairment testing requirements for not-for-profit entities leverages this guidance to determine reporting units. Here, ABC System has two reportable segments, RS1 and RS2.

OS = The operating segments determined under segment reporting guidance. ABC System has three operating segments, OS1, OS2 and OS3. ABC System determined that OS1 and OS2 have similar economic characteristics and meet the criteria for aggregation. OS3 meets the quantitative thresholds to be reported separately and has not been aggregated with any other operating segment. It is therefore the same as reportable segment RS2.

C = The components of the company. ABC System has seven components, C1, C2, C3, C4, C5, C6 and C7, which are one level below the operating segments.

Determining the reporting units of ABC System begins at the operating segment level, OS1, OS2 and OS3. The goodwill impairment guidance does not allow the aggregation of OS1 and OS2 as permitted under the guidance for determining reportable segments.

ABC System will apply the reporting unit criteria in the goodwill impairment guidance to the components to determine whether the reporting unit should be identified one level below the operating segment. Each component will be evaluated to determine whether 1) it is a business, 2) discrete financial information is available, and 3) the operating results are regularly reviewed by the segment manager(s). If the components of a specific operating segment meet these criteria, they might be deemed to be separate reporting units. However, if they have similar economic characteristics, which is a matter of judgment based on individual facts and circumstances, these components must be aggregated into one reporting unit.

For example, assume C5, C6 and C7 each are businesses for which discrete financial information is available, and segment OS3 management regularly reviews their individual operating results. If C5, C6 and C7 all have dissimilar economic characteristics, then OS3 would have three reporting units, as each of the components would be a reporting unit. If C5 and C6 have similar economic characteristics, but C7 does not have similar economic characteristics to C5 and C6, then OS3 would

have two reporting units: C5 and C6 combined, and C7. If C5, C6 and C7 all have similar economic characteristics, the reporting unit would be the operating segment, OS3.

Components of different operating segments may not be aggregated, even if they have similar economic characteristics. As such, in our example, because C2 and C3 are components of different operating segments, they may not be aggregated.

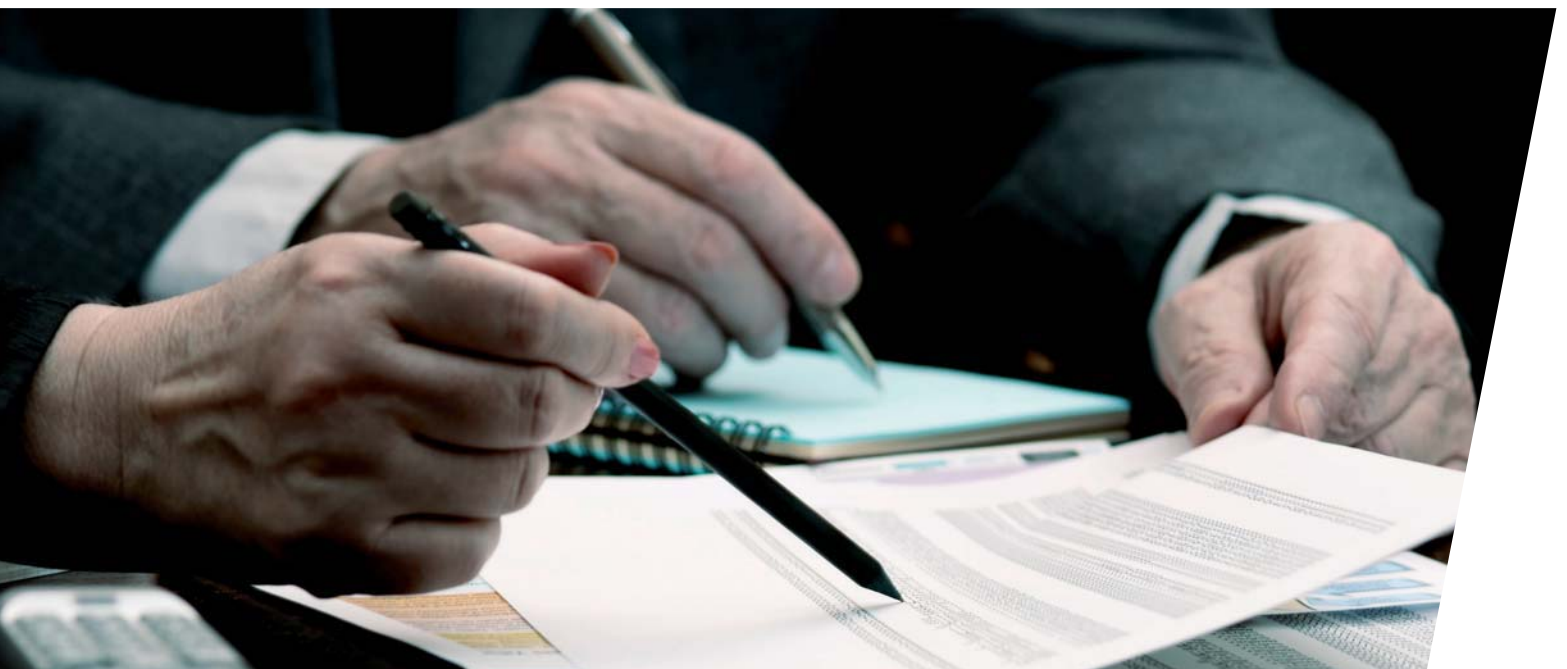
In summary, ABC System will have at least three reporting units because three operating segments have been identified. The System could have as many as seven reporting units - the number of components. The number will depend on how many components are businesses with discrete financial information reviewed regularly by management, and how these can be aggregated based on similarity of economic characteristics (which is based on judgment). Even if levels exist below the components that meet the reporting unit criteria, the goodwill impairment guidance prohibits identifying the operating unit more than one level below the operating segment.

Implementing the new requirements

For not-for-profit health care organizations, implementing the new guidance on goodwill impairment testing will be a challenging process. Table 2 presents nine steps for effective outcomes.

Table 2. Nine action steps for successful implementation

1. Designate an implementation project team, including financial accounting and reporting personnel, external auditors and external valuation specialists.
2. Determine the effective date of the new guidance for your organization.
3. Establish a timeline, including when the transitional goodwill impairment test will be performed.
4. Identify existing goodwill resulting from previous business combinations.
5. Determine reporting units for the consolidated organization and reporting units for separate subsidiary financial statements.
6. Ensure that implementation project team members agree on key assumptions, including identification of reporting units, the timing of the transitional goodwill impairment test, and the application of fair value measurements
7. Perform steps 1 and 2 of the goodwill impairment model, including the involvement of valuation specialists.
8. Evaluate the impact of the new guidance on your organization's financial statements, including interim financial statements, and prepare required footnote disclosures.
9. Establish a policy for the subsequent annual goodwill impairment test, including the date(s) during the year the tests will be performed.



A challenging process – Ernst & Young can help

An organization has six months from the date it adopts the new guidance to complete step 1 of the transitional goodwill impairment test. However, the amounts used in the transitional test should be measured as of the beginning of the year of adoption. If step 2 of the transitional goodwill impairment test is required, it must be completed as soon as possible, but no later than the end of the year of adoption of the new guidance. An impairment loss recognized as a result of the transitional impairment test is recognized as the effect of a change in accounting principle. Not-for-profit health care organizations are required to present any transitional impairment loss in the statement of operations and changes in net assets outside the performance indicator or any intermediate measure of operations, if an intermediate measure is presented.

For not-for-profit health care organizations that report on an interim basis – for example, organizations that file quarterly statements with the Electronic Municipal Market Access (EMMA) system pursuant to their tax-exempt debt and continuing disclosure agreements – any transitional

impairment loss must be reported in the first interim period regardless of the period in which an impairment loss is measured. As a result, we believe most not-for-profit health care entities will complete the transitional impairment test during their first quarter to avoid future restatements of their interim financial statements.

We also believe many not-for-profit health care entities will engage third-party specialists to assist in determining the fair value measurements required in the two-step goodwill impairment test. To avoid potential issues later, it is important that management, the third-party valuation specialists and the entity's independent auditors agree on key assumptions impacting the goodwill impairment tests, including determining reporting units and measuring fair value.

Ernst & Young is a leader in providing assurance services to the provider care sector. The goodwill impairment requirements are complex and will present implementation challenges to not-for-profit health care organizations. We welcome the opportunity to discuss any technical accounting and reporting matter, including how we can assist you in implementing the new guidance on accounting for goodwill.

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