Case 22-8c

Goodwill Risk Assessment

Introduction

This case illustrates how auditors conduct a risk assessment for the audit of management's assertion regarding whether the goodwill asset at a client continues to have a fair value greater than its carrying value. Testing for goodwill impairment can be relatively straightforward or highly complex, and is highly dependent on a company's facts and circumstances. Thus, in assessing risk, the auditor needs to consider the company's structure, the consistency of its processes for impairment testing, the relevant accounting guidance, the complexity of the valuation model(s) used, and the various business and valuation assumptions used to determine fair value.

An appropriate risk assessment for the valuation assertion of goodwill begins with a thorough understanding of the reporting units, the valuation methods and models applied, and the business and valuation assumptions used in the valuation models. An understanding of the relevant accounting and auditing guidance is also required.

Certain facts and circumstances can have a significant impact on the results of the goodwill impairment test and the auditor's risk assessment. The following are some examples:

- An entity operating in a single segment with a single reporting unit would likely have a different level of risk compared to an entity operating in multiple segments with multiple reporting units.

- The historical experience in testing goodwill values could influence the level of competence and experience of the accountants responsible for preparing the impairment test(s) and could also influence the involvement of appropriate external resources to assist with valuation. An experienced company team with appropriate resources can reduce the risk associated with goodwill impairment testing.

- A discounted cash flow (DCF) model that is based on poor quality forecasts that are subject to an ad hoc or otherwise inadequate forecasting process would have a different level of risk compared to a DCF model using high-quality forecasts subject to a rigorous and thorough forecasting process.

This case study uses a fictional company and a financial statement audit of that company. The case assumes the auditor has already completed its risk assessment procedures and has also obtained an understanding of internal control and the company's process for testing goodwill for impairment. The facts obtained from those procedures have been summarized for risk assessment considerations and conclusions. Background information about the fictional company is provided, along with relevant discussion questions.

When completing the case study, refer to the following guidance in paragraph .59(c) and (d) of PCAOB AS 2110:

c. Evaluate the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected.

d. Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements.

This case study contains three underlying sets of case facts (examples). Each example requires responses to the following three tasks/questions:

1. In the provided risk toggles, place an X on each toggle according to your perceived level of inherent risk on the basis of the case facts that have been provided to you. Be prepared to discuss your response.

2. Select a particular toggle category (e.g., "Company-Specific Factors," "Business Assumptions," "Valuation Assumptions"), and identify a type of potential misstatement (risk statement) specific to that category. For example, a risk statement for "Valuation Assumptions" could be "management's control premium used in the market approach fair value measurement is not reasonable."

3. For the risk statement identified in Question 2, evaluate the likelihood and magnitude of potential misstatement and assign a risk rating using the following scale: Remote (no risk of material misstatement), Lower, Higher, or Significant. Be prepared to discuss your risk rating.

Background Information

Whole World Wide Hotels Inc. (WWWH or the "Company") is a public entity with a December 31 fiscal year-end. WWWH is a leader in the hospitality industry and operates hotels and resorts around the world. WWWH has total assets of approximately $3.5 billion. WWWH management has defined three operating segments that are geographically oriented: (1) Americas, (2) Europe, and (3) Asia.

The case study will focus on the Americas operating segment, which includes the following reporting units: (1) Boutique Hotels, (2) Legacy Hotels, and (3) Online Vacation Rentals. For purposes of our case study, we are assuming that each represents a reporting unit to test goodwill for impairment (the components meet the definition of a reporting unit under U.S. GAAP).

Although business has been steady and remains highly profitable, the Boutique Hotels and Online Vacation Rentals reporting units are gaining in popularity, especially in certain key markets in the United States (New York, Chicago, San Francisco, and Los Angeles). As a result, management acquired two businesses in the prior year (Urban Oasis Resorts Inc. and Online Vacation Rentals Inc.) to help take advantage of the new opportunities and to further diversify the Company. General economic conditions are stable, unemployment is low, and economists expect modest growth in the overall economy in the next few years. There is no indication that the travel and leisure industry will be affected significantly by economic conditions in the near future.

Management tests all Americas reporting units for impairment on July 1 using various valuation techniques further described below. Materiality for WWWH has been set at $50 million by the audit team. The following graphic summarizes the reporting units that will be the focus of this case study.

Example 1 — Boutique Hotels Reporting Unit

Additional case facts relevant to the annual impairment test for the Boutique Hotels reporting unit:

- Luxury Lane Hotels (goodwill of $100 million) was acquired several years ago and has been highly profitable since acquisition. Urban Oasis Resorts Inc. (goodwill of $55 million) was acquired in the prior year.

- To determine fair value for Boutique Hotels, management has selected two valuation techniques (a DCF and a guideline public company market approach), which are equally weighted. This fair value method is consistent with the method used for this reporting unit in prior years.

- Although the original valuation models were developed by a reputable third-party expert, management performs the updated impairment test each year, relying on the externally developed model (management just updates assumptions and performs calculations).

- The DCF is based on internal forecasts that are subject to a rigorous process, and management has demonstrated the ability to make accurate forecast. The forecasts are consistently used for other internal analyses and tracking.

- Management projects revenue and margin growth will be slightly higher than historical and industry expectations.

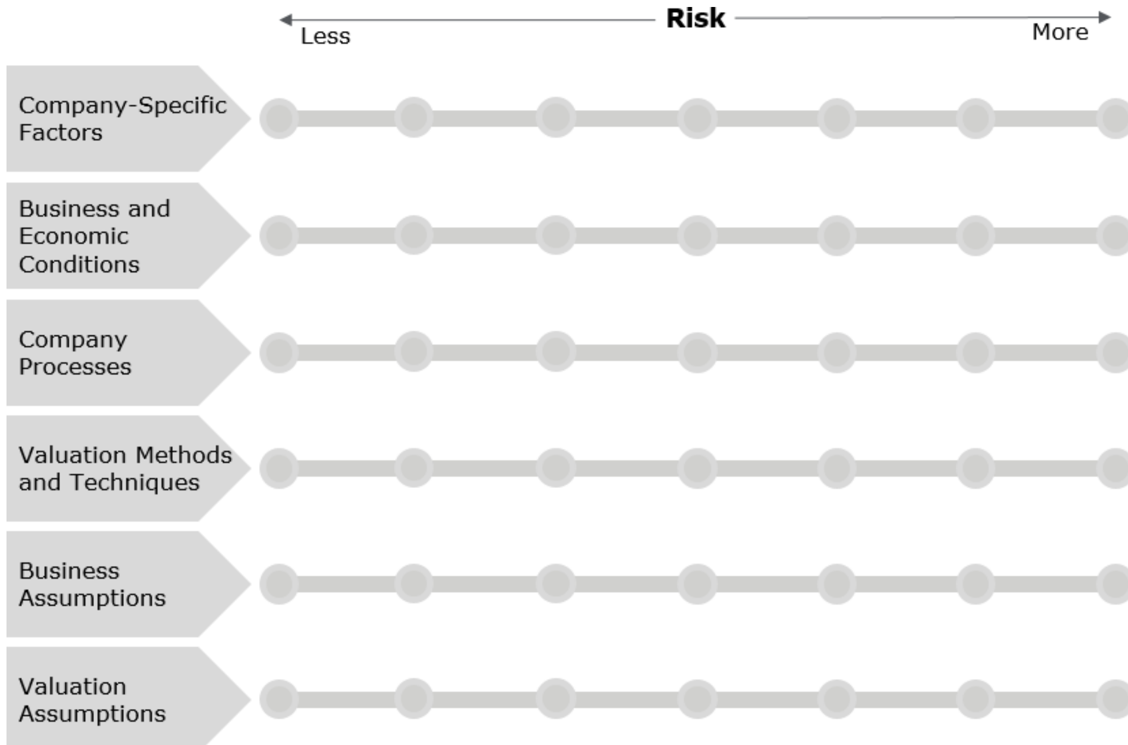
- The boutique hotel industry is currently in a state of high growth driven by an increase in demand for high-end boutique hotels.

- The discount rate and all other valuation assumptions used are consistent with those assumptions used in the prior year, which is consistent with general economic and industry trend analysis completed by the auditor's Internal Fair Value (IFV) specialists. The consistency in valuation assumptions with the prior year is also consistent with the changes in industry discount rate ranges, forecasted economic and industry growth rates, and average and median guideline public company multiples, which are also provided by the auditor's IFV specialists. Revenue and earnings before interest, taxes, depreciation, and amortization (EBITDA) assumptions have a low degree of sensitivity.

- The market approach uses earnings multiples and comparable companies to determine the fair value of the reporting unit. The earnings multiples selected are often used in the industry to value boutique hotel businesses. The comparable companies include other similar-sized boutique hotel chains that have public information available. The comparable companies used are consistent with those used by the compensation committee to benchmark compensation for boutique management.

- Resulting fair value exceeds carrying value by 30 percent, which is a slight increase from 25 percent in the prior year. The resulting fair value under both approaches (DCF and market) are consistent and both value indications are higher than the carrying value.

Question 1: In the provided risk toggles, place an X on each toggle according to your perceived level of inherent risk on the basis of the case facts that have been provided to you. Be prepared to discuss your response.



Question 2: For the "Valuation Assumptions" and the "Business Assumptions" toggle categories, identify a type of potential misstatement (risk statement) specific to each category. For example, a risk statement for "Valuation Assumptions" could be: "Management's control premium used in the market approach fair value measurement is not reasonable."

Question 3: For the risk statements identified in Question 2, evaluate the likelihood and magnitude of the potential for misstatement and assign a risk rating using the following scale: Remote (no risk of material misstatement), Lower, Higher, or Significant. Be prepared to discuss the rationale for your risk rating.

Example 2 — Legacy Hotels Reporting Unit

Additional case facts relevant to the annual impairment test for the Legacy Hotels reporting unit:

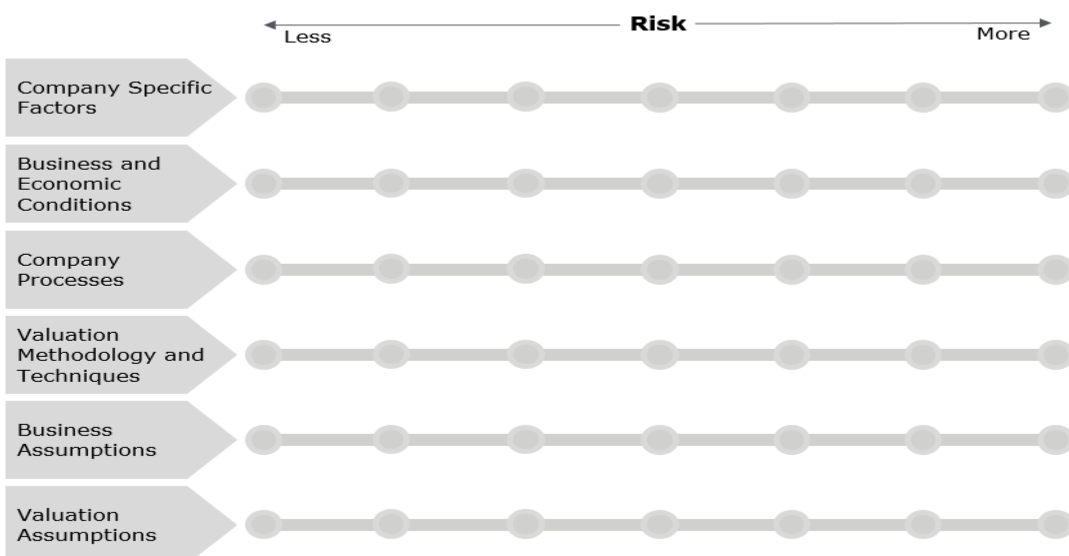
- Legacy Hotels comprises legacy WWWH chain hotels and other hotel chains purchased by WWWH that were consolidated into existing legacy brands.
- The chain hotel industry is currently in a relatively stable state, but it is experiencing slight declines in revenues driven by an increase in demand for high-end boutique hotels and online vacation rental homes, which has eroded demand for hotel chains.
- Revenues and margins for chain hotels are expected to remain flat, with some industry analysts expecting slight declines as a result of the growing popularity of online vacation rentals and boutique hotels.
- To determine fair value for the reporting unit, management has selected two valuation techniques (a DCF and a guideline public company market approach) that are equally weighted. This fair value method is consistent with the method used for the Legacy Hotels in prior years.
- The DCF is based on internal forecasts that are subject to a rigorous process; the forecasts are consistently used for other internal analyses and tracking. Management projects revenue and margin growth over the next five years of 1 percent to 2 percent per year. Revenue and EBITDA have a high degree of sensitivity (changing both assumptions by 3 percent per year would cause fair value to equal carrying value).
- Changes in the discount rate and other valuation assumptions used in the DCF analysis are consistent with industry trend analysis completed by the auditor's IFV specialists and are also consistent with the changes in industry discount rate ranges, forecasted economic and industry growth rates, and average and median guideline public company multiples, also provided by the auditor's IFV specialists. The discount rate assumption has a high degree of sensitivity (changing the discount rate by only 50 basis points would cause fair value to equal carrying value).
- The market approach uses earnings multiples and comparable companies to determine the fair value of the reporting unit. The earnings multiples selected are often used in the industry to value hotel businesses. The comparable companies include other similar-sized hotel chains that have public information available. The comparable companies used are consistent with those used by the compensation committee to benchmark compensation for boutique management; however, management has excluded certain companies on the belief that those companies do not align well with the reporting unit.
- Management also selected a control premium of 30 percent for use in the guideline public company market model. Such control premium is higher than the 25 percent average premium supported by recent industry transaction information provided by our specialists.

The difference is caused by management's exclusion of certain transactions that occurred because of perceived inconsistencies with the business.

- A well-known and reputable third-party valuation firm was engaged to assist with the valuation. The firm has consistently been used by management for the valuation for several years.

- Resulting fair value exceeds carrying value by 25 percent, which is slightly lower than the 30 percent cushion from the prior year's test. The resulting fair value from the market approach is 5 percent lower than the resulting fair value from the DCF approach. Management has reconciled the results from the two approaches and believes the difference is related to investor pessimism toward traditional hotel brands (brought on by the perceived threats from boutique hotels and online vacation rentals), which it believes is negatively affecting stock prices of the comparable companies, and thus driving down the results of the market model.

Question 1: In the provided risk toggles, place an X on each toggle according to your perceived level of inherent risk, on the basis of the case facts that have been provided to you. Be prepared to discuss your response.



Question 2: For the "Valuation Assumptions" and the "Business Assumptions" toggle categories, identify a type of potential misstatement (risk statement) specific to each category. For example, a risk statement for "Valuation Assumptions" could be: "Management's control premium used in the market approach fair value measurement is not reasonable."

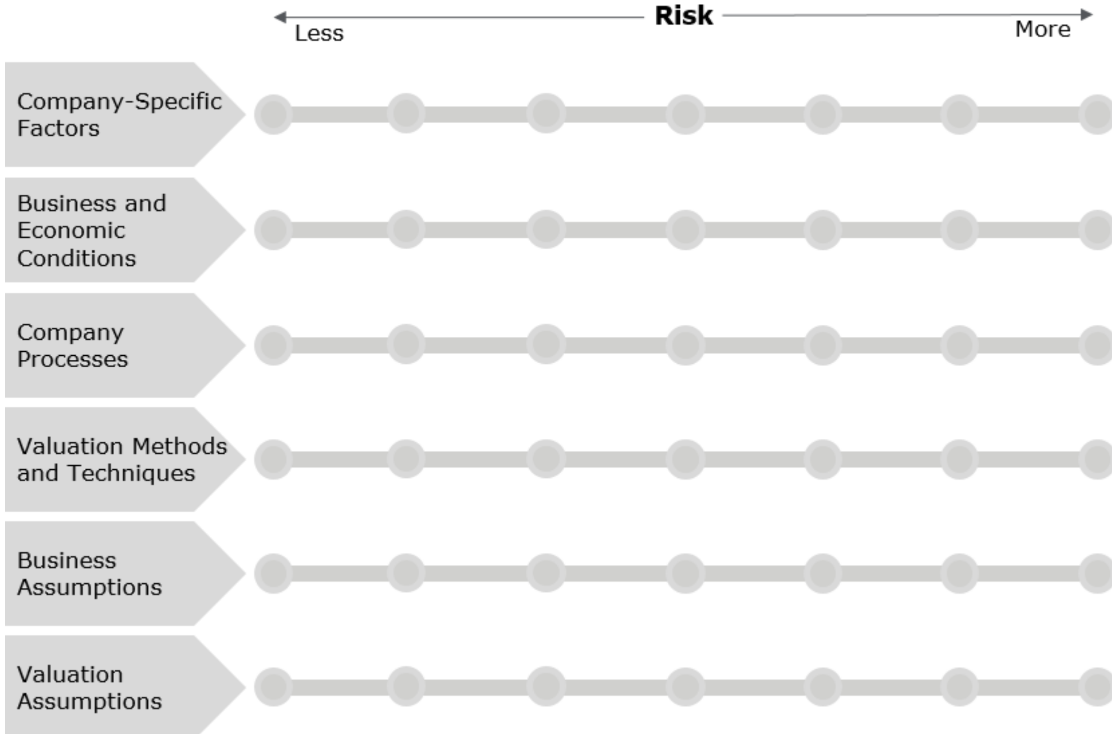
Question 3: For the risk statements identified in Question 2, evaluate the likelihood and magnitude of the potential for misstatement and assign a risk rating using the following scale: Remote (no risk of material misstatement), Lower, Higher, or Significant. Be prepared to discuss the rationale for your risk rating.

Example 3 — Online Vacation Rentals Reporting Unit

Additional case facts relevant to the annual impairment test for the Online Vacation Rentals reporting unit:

- The reporting unit consists of the newly acquired Online Vacation Rentals Inc. business.
- The online vacation rental space is a relatively new industry that is in an aggressive growth phase and is highly competitive. Although revenues are increasing at a high rate, those increases are mostly offset by the increased marketing and advertising costs associated with aggressively trying to win market share.
- Revenues are expected to grow by 5 percent to 10 percent per year; the large range appears to be caused by the higher level of uncertainty associated with the market for online vacation rentals and the difficulty analysts have in forecasting for this business.
- Most analysts expect margins to remain small over the next few years given the aggressive spending on marketing and advertising.
- To determine fair value for the reporting unit, management has selected one valuation technique, a DCF approach. Management cited the lack of comparable companies in the online vacation rental space as their rationale for not using a guideline public company market value model. Most competitors are privately owned; thus, obtaining sufficient public information to perform the analysis is not possible.
- The DCF is based on internal forecasts that are subject to a rigorous process (the same process used by the other reporting units); the forecasts will be consistently used for other internal analyses and tracking. This is the first full forecast that management has prepared for Online Vacation Rentals. Management projects revenue and margin growth will be slightly above industry expectations.
- The discount rate used in the DCF is much higher than the other reporting units because of a higher company-specific risk premium, which adjusts for uncertainty of future cash flows. The discount rate assumption has a high degree of sensitivity (changing the discount rate by only 50 basis points would cause fair value to equal carrying value). Revenue and EBITDA also have a high degree of sensitivity (changing both assumptions by 1 percent per year would cause fair value to equal carrying value).
- A well-known and reputable third-party valuation firm was engaged to assist with the valuation. The firm is the same firm engaged to assist with valuation for the Legacy Hotels.
- Resulting fair value exceeds carrying value by 5 percent.

Question 1: In the provided risk toggles, place an X on each toggle according to your perceived level of inherent risk, on the basis of the case facts that have been provided to you. Be prepared to discuss your response.



Question 2: For the "Valuation Assumptions" and the "Business Assumptions" toggle categories, identify a type of potential misstatement (risk statement) specific to each category. For example, a risk statement for Valuation Assumptions could be: "Management's control premium used in the market approach fair value measurement is not reasonable."

Question 3: For the risk statements identified in Question 2, evaluate the likelihood and magnitude of potential misstatement and assign a risk rating using the following scale: Remote (no risk of material misstatement), Lower, Higher, or Significant. Be prepared to discuss your risk rating.