## Case 11-9

## Goodwill Impairment Testing

- Galaxy Sports Inc. (Galaxy or the Company), a U.S.-based manufacturer of sports equipment, is a calendar year-end SEC registrant with one operating segment and the following three reporting units:
    - Fitness Equipment.
    - Golf Equipment.
    - Hockey Equipment.
- Galaxy is in a competitive industry with several publicly traded companies in which growth and profitability are tied to the market and consumer demand.
- Three reporting units are appropriate because discrete financial information is available for each component, each component is a business, and each component is managed separately.
- The Fitness Equipment component is Galaxy's largest reporting unit. Over the years, various acquisitions have resulted in recorded goodwill of $200 million assigned entirely to this reporting unit.
- The Golf Equipment component is a large golf equipment manufacturer that was acquired in 2004. Upon acquisition of the business, Galaxy recorded $130 million of goodwill that was assigned entirely to this reporting unit.
- The Hockey Equipment component is a small hockey equipment manufacturer acquired in 2003 to gain entry into the very profitable hockey equipment market. Galaxy recorded $30 million of goodwill related to this acquisition, which was assigned entirely to this reporting unit.
- Galaxy has elected an annual goodwill impairment testing date of December 31 for all three reporting units.

In December 20X1, Galaxy management engaged Big Time LLC (Big Time), a reputable external valuation firm, to perform three annual ASC 350, *Intangibles — Goodwill and Other*, impairment analyses (one for each reporting unit) on the $360 million of goodwill recorded by Galaxy as of December 31, 20X1. Previously, management had performed the annual goodwill impairment analysis internally. However, given the increasing complexities involved in the calculation and resource constraints at Galaxy, the Company decided to use a third party.

In early discussions between Galaxy's management and Big Time, management indicated that because each of the three reporting units had significant cushion (i.e., the estimated fair value of each reporting unit significantly exceeded the book value), the reporting units would continue to pass step 1 of the goodwill impairment test. The internal goodwill impairment analysis performed by Galaxy in the previous year demonstrated each reporting unit passed step 1 of the goodwill impairment test.

Galaxy management indicated that the significant cushion was likely because 20X1 Q4 sales were very strong, and strong sales were also expected for 20X2 and beyond. Big Time completed its analysis in late January 20X2 and, as expected, Galaxy passed step 1 of the annual goodwill impairment test for each reporting unit. Galaxy's common share price was $56.75 as of December 31, 20X1.

**Galaxy December 31, 20X1, ASC 350 Goodwill Impairment Analysis Summary (Prepared by Big Time)**

**Step 1 Test**
($US in thousands)

| **Reporting Unit** | **Fair Value of Equity** | **Book Value of Equity** | **Step 1 Passed?** |
|---|---|---|---|
| Fitness Equipment | $1,310,000 | $750,000 | Yes |
| Golf Equipment | 650,000 | 300,000 | Yes |
| Hockey Equipment | 1,120,000 | 225,000 | Yes |
| Total | $3,080,000 | $1,275,000 | |
| Market capitalization | $2,610,500 | | |
| Implied control premium | 18% | | |

***Note*:** As of December 31, 20X1, Galaxy's share price was $56.75 and 46 million shares were outstanding, indicating a market capitalization of $2.6 billion. The implied control premium of 18 percent is viewed by management as reasonable.

**First Quarter of 20X2**

Galaxy adopted ASU 2011-08, *Testing Goodwill for Impairment*, for the year ending December 31, 20X2 (including interim periods therein).

Management released Q1 earnings, which were slightly below expectations. In a Q1 press release, Galaxy attributed the lower earnings to the slowing economy and reduced consumer spending on recreational activities. Galaxy's common share price fell to $49.25 after the release of Q1 earnings.

**Second Quarter of 20X2**

Management released Q2 earnings on July 15, 20X2. As in Q1, Q2 earnings were also below expectations because the slowing economy resulted in continuing reductions in consumer spending. In Galaxy's press release, management discussed the impact of the slowing economy on its business. Further, the Company experienced additional pressure on its sales during the quarter as a result of an increase in sports equipment manufactured in China that was being sold at large discount retailers. The equipment has a lower price point, which is appealing to consumers during difficult economic times. Historically, Galaxy has not experienced significant competition from imports because the quality of the imports is inferior to the quality of the sports equipment manufactured by Galaxy. Galaxy's common share price fell to $45.25.

**Third Quarter of 20X1**

During the financial close process, management considered performing an interim goodwill impairment test but, after reviewing ASC 350, determined it was not necessary.

Management released earnings on October 15, 20X2, and indicated that although Q3 earnings were significantly below expectations because of a continued slowing economy and reduced consumer spending, revenue would rebound in Q4 as retailers stocked up for the holiday shopping season. Historically, Q4 has been the strongest quarter for Galaxy with Q4 sales representing more than 50 percent of the Company's annual sales. Galaxy's common share price fell to $31.50 after the earnings release.

**Year-End 20X2**

As Galaxy prepared for its annual goodwill impairment test, management determined that (1) assets and liabilities of the Fitness Equipment and Hockey Equipment reporting units had not significantly changed, (2) the most recent fair value determinations (the 20X1 analysis prepared by Big Time) for both reporting units resulted in an amount that exceeded the carrying amounts by substantial margins, and (3) on the basis of its judgment, there have been no significant events or circumstances that would lead Galaxy to believe the fair value is more likely than not to fall below the carrying amount of both reporting units. As a result, management decided not to perform a step 1 impairment analysis for the Fitness Equipment and Hockey Equipment reporting units. For the Golf Equipment reporting unit, management used the analysis created by Big Time last year and updated it as of December 31, 20X2, by using the same growth rate and discount rate as in the prior year.

On the basis of this updated analysis, management concluded that the Golf Equipment reporting unit passed step 1. A summary of Galaxy's 20X2 annual goodwill impairment test follows:

**Galaxy December 31, 2012, ASC 350 Goodwill Impairment Analysis Summary**

**Step 1 Test**
($US in thousands)

| **Reporting Unit** | **Fair Value of Equity** | **Book Value of Equity** | **Step 1 Passed?** |
|---|---|---|---|
| Fitness Equipment * | $1,310,000 | $700,000 | Yes |
| Golf Equipment | 590,000 | 300,000 | Yes |
| Hockey Equipment * | 1,120,000 | 250,000 | Yes |
| Total | $3,020,000 | $1,250,000 | |
| Market capitalization | $1,375,000 | | |
| Implied control premium | 120% | | |

* We have elected to perform a qualitative impairment assessment as of December 31, 20X2.

***Note*:** On December 31, 20X2, Galaxy's share price was $27.50 and 50 million shares were outstanding, indicating a market capitalization of $1.375 billion. We firmly believe that the reporting unit fair values represent management's view of the Company's business and expectations. The market has undervalued the Company's stock. Accordingly, the implied control premium of 120 percent is viewed by management as reasonable given the overall market climate.

Galaxy released year-end earnings on January 25, 20X3. On the basis of the annual earnings release and the lack of an expected Q4 rebound, Galaxy's common share price fell even further, from $27.50 on December 31, 2012, to $21.25 after the earnings release.

Galaxy filed its December 31, 20X2, Form 10-K on February 10, 20X3.

**Required:**

- Should management have performed an interim goodwill step 1 impairment test as of September 30, 20X2?
- Assume no interim step 1 test is required. Was management justified in performing a qualitative impairment assessment for the Fitness Equipment and Hockey Equipment reporting units?