Case 14-5
Quality Waste Removal

Company Information

Eastmond Waste (EW or the “Company”) is a nonpublic regional waste removal company that operates primarily in the Midwest. The Company earns revenues from residential and commercial garbage and recycling collections.

A summary of EW’s financial results as of and for the year ended December 31, 2011, is as follows:

	12/31/2011 (in millions)	
Assets		
Cash	$	12
Receivables		33
Other current		9
Current assets		54
Property, net		131
Goodwill		112
Identifiable intangible assets, net		17
Other assets		6
Total assets	$	320
Liabilities and equity		
Accounts payable & accrued expenses	$	14
Line of credit		23
Current portion of long-term debt		15
Other		8
Current liabilities		60
Long-term debt		211
Equity		49
Total liabilities and equity	$	320

	12/31/2011 (in millions)	
Income summary		
Revenues	$	255
Operating expenses		158
SG&A expenses		49
Interest expense		12
Taxes		13
Net income	$	23

Growth Strategy

The Company actively seeks out local waste companies in its current or adjacent markets. Acquisitions of businesses inside EW’s territory are referred to as “tuck-in acquisitions.” Tuck-in acquisitions allow the Company to expand its revenue base and at the same time reduce its cost per customer. (Cost reductions are primarily the result of improved route efficiencies.). Expanding into new markets provides another means of revenue growth and provides another market in which the Company may be able to add tuck-in acquisitions in the future.

Acquisition Process

The acquisition group is overseen by Yvonne Upton, acquisition director, and Carter King, acquisition manager. Both are actively involved in identifying potential acquisition targets. Before formal negotiations can begin, the Company enters into a nondisclosure agreement with the target, when it seeks information related to the target's revenues and customer base. As part of the nondisclosure agreement, the target provides financial information to EW. Ms. Upton and Mr. King analyze the revenues of the target and perform due diligence procedures to evaluate the data provided. Mr. King (1) works with operations management to estimate how the target's cost structure would change under the Company's cost structure and (2) analyzes synergies to the extent they exist. Mr. King then analyzes any other factors that are part of the negotiations, including the real estate and equipment included in the deal, any unusual contracts present, and the quality of the target's relationships. Ms. Upton reviews this analysis and ultimately provides a recommendation to the board of directors related to the target and a suggested acquisition price. If the acquisition is recommended, Ms. Upton provides a suggested acquisition price, which is supported by the acquisition group's analysis.

After an acquisition is completed, the Company uses Sky Valuations LLC, a regional valuation firm, to assist the acquisition group to determine the appropriate purchase price allocation. Typically, most of the purchase price is assigned to goodwill, the remainder is assigned to identifiable intangible assets (customer lists and noncompete agreements), property and equipment, and accounts receivable.

Goodwill Considerations and the Adoption of Step Zero

The Company's chief operating officer, P. Ernest Worrell, is EW's chief operating decision maker. The Company has historically been managed as one reporting unit consisting of its collection operations.

The Company's annual goodwill assessment date is December 31. Historically, the annual assessment was made up of a two-step process described in ASC 350-20-35, which included (1) an analysis of whether an impairment existed (by determining whether the fair value of a reporting unit is less than its carrying value) and (2) a measurement of the impairment (which is only necessary if the fair value of a reporting unit is less than its carrying value).

EW historically used Sky Valuations to assist in this annual assessment. During each of the last three years, the Company had concluded that the fair value of its collection reporting unit was greater than its carrying value. In its most recent assessment performed as of December 31, 2011, the fair value of the Company was determined to be $230 million compared to its carrying value of $49 million, providing a cushion greater than $180 million.

As of January 1, 2012, the Company adopted ASU 2011-08, *Testing Goodwill for Impairment,* which allows it to assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. After performing this qualitative assessment, which is known as “step zero,” the Company is only required to perform step 1 (identification of potential impairment) if management determines that it is more likely than not that the fair value of the reporting unit is less than its carrying value.

Current-Year Acquisition

In January 2012, EW entered into an agreement to purchase MW Trash Brothers (Trash Bros) for $100 million. Trash Bros operated waste removal businesses in many of the same markets that the Company operated in, but, more importantly, it also operated six landfills within EW’s footprint. The landfills will allow EW to reduce its disposal costs and earn revenues off of its competitors from their disposals.

The acquisition closed on March 15, 2012, when Trash Bros’s residential and commercial collection operations were folded into EW’s collection operations. However, Trash Bros’s landfill director was retained by EW and became the VP of landfill operations at EW. He currently serves directly under Mr. Worrell. Since the acquired waste removal businesses are similar to EW’s existing collection business, the acquired waste removal businesses were added to EW’s collections operation reporting unit.

The Company’s controller, Oscar T. Grout, determined that the landfill division was a new reporting unit because the business was dissimilar from its other reporting units and would be managed separately. Mr. Grout directed the monthly reporting provided to Mr. Worrell to discreetly present the landfill operations separately from the collections operations.

Sky Valuations assisted management in allocating the purchase price, which ultimately resulted in additional goodwill of $65 million, of which $30 million was related to the new landfill reporting unit.

Current Year Step-Zero Analysis

In the current year, management moved forward with a qualitative assessment of both reporting units. Mr. Grout prepared the analysis that was reviewed by the Company’s CFO.

Required:

- Accounting considerations:
    - Question 1A: Can management apply a step-zero analysis to both reporting units as of December 31, 2012, current-year measurement date?
    - Question 1B: If so, what is an appropriate measure of fair value (herein referred to as the entity’s “baseline” measure of fair value) for the entity to use to perform the qualitative assessment of goodwill on the newly acquired reporting unit?

  - Question 1C: The newly acquired reporting unit will most likely have a very low cushion; what affect would this have on the conclusions of the qualitative assessment? (Consider ASC 350-20-35-3F and 35-3G when developing your response.)
- Control considerations:
  - Question 2: What controls should management have in place to appropriately perform the step-zero analysis for its reporting units?
- Audit considerations:
  - Question 3: What audit procedures should be performed to evaluate the step-zero analysis?