Simplified accounting for private companies: Goodwill

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A. General

Accounting Standards Update (ASU) 2014-02, *Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill*, introduced an accounting alternative for private companies that simplifies the subsequent accounting for goodwill.

The differences in a private company’s accounting for goodwill if it elects the goodwill alternative as its accounting policy are summarized in the following table:

<table>
<thead>
<tr>
<th>Goodwill alternative is elected</th>
<th>Goodwill alternative is not elected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization of goodwill</td>
<td>Yes, over a period not to exceed 10 years (see Section C)</td>
</tr>
<tr>
<td>Level at which impairment testing is performed</td>
<td>Choice of entity level or reporting unit level (see Section D)</td>
</tr>
<tr>
<td>Frequency of impairment testing</td>
<td>When there is a triggering event (see Section E)</td>
</tr>
<tr>
<td>Testing and measuring goodwill for impairment</td>
<td>When the carrying amount of the entity (or reporting unit) is greater than its fair value, recognize an impairment loss for the excess, not to exceed the carrying amount of goodwill (see Section F)</td>
</tr>
</tbody>
</table>

If the goodwill alternative is elected, all aspects of it must be elected. In other words, a private company cannot elect to apply the impairment guidance and not elect to apply the amortization guidance.

There is another accounting alternative for private companies related to the identifiable intangible assets recognized in the accounting for a business combination, which is discussed in our white paper, *Simplified accounting for private companies: Certain intangible assets*. While a private company may elect the goodwill alternative without electing the intangible asset alternative, it may not elect the intangible asset alternative without electing the goodwill alternative.

**Pending change:** The Financial Accounting Standards Board (FASB) has a project on its agenda, *Identifiable Intangible Assets and Subsequent Accounting for Goodwill*, which could significantly affect
the goodwill impairment guidance referred to in this white paper. At the publication date for this white paper, the project was still in process (see the FASB’s project page for its status).

A.1 ASU 2017-04

ASU 2017-04 simplified the testing of goodwill for impairment for public business entities (PBEs) and other entities that have not elected the goodwill alternative. The two primary simplifications provided were:

- Eliminating Step 2 from the goodwill impairment model and calculating any impairment charge based on the excess of the carrying amount of the reporting unit over its fair value (net of any related tax effect), not to exceed the carrying amount of the reporting unit’s goodwill
- Recognizing no goodwill impairment charge when the reporting unit has a zero or negative carrying amount

These simplifications are effective for PBEs that are Securities and Exchange Commission (SEC) filers, except for entities eligible to be a smaller reporting company (as defined by the SEC) in annual and any interim impairment tests performed for periods beginning after December 15, 2019. For all other entities that have not elected the goodwill alternative, these simplifications are effective in annual and any interim impairment tests performed for periods beginning after December 15, 2022. Early adoption is permitted for all entities. For additional information about the changes made by ASU 2017-04, see our white paper, Simplifying the test for goodwill impairment.

A private company that has elected the goodwill alternative is permitted (but not required) to change to the goodwill guidance in U.S. generally accepted accounting principles (GAAP) applicable to PBEs and other entities that have not elected the goodwill alternative (as amended by ASU 2017-04). However, the manner in which it does so depends on whether it has previously elected only the goodwill alternative or both the goodwill and intangible asset alternatives. When the private company has only previously elected the goodwill alternative, it does not have to justify the preferability of changing to the goodwill guidance in U.S. GAAP applicable to PBEs and other entities that have not elected the goodwill alternative, provided it makes the change on or before the effective date of ASU 2017-04. When the private company has previously elected the goodwill and intangible asset alternatives, it must follow the guidance in Topic 250, Accounting Changes and Error Corrections, of the FASB’s Accounting Standards Codification (ASC) when changing to the goodwill guidance in U.S. GAAP applicable to PBEs and other entities that have not elected the goodwill alternative, which includes justifying why the change is preferable and retrospective application of the change.

B. Scope

Private companies and not-for-profit entities that may elect the goodwill alternative include entities other than the following: (a) those that meet the definition of a PBE as defined in the Master Glossary of the Codification or (b) employee benefit plans that fall within the scope of ASC 960, Plan Accounting—Defined Benefit Pension Plans, ASC 962, Plan Accounting—Defined Contribution Pension Plans, and ASC 965, Plan Accounting—Health and Welfare Benefit Plans.

If elected, the goodwill alternative applies to all new and existing goodwill. In other words, the goodwill alternative cannot be elected for the goodwill related to some acquisitions, but not the goodwill related to other acquisitions. The goodwill alternative also applies to the excess reorganization value that may arise in applying fresh-start reporting as described in ASC 852, Reorganizations. In addition, the amortization component of the goodwill alternative applies to equity method goodwill, which is a component of an investor’s equity method investment (i.e., it is not recorded separately from the equity method investment). As a result, when the goodwill alternative is elected, an investor includes amortization of equity method goodwill in the equity method income or loss it recognizes. However, equity method
goodwill is not tested for impairment separate from the overall equity method investment. In other words, neither the goodwill alternative nor the legacy goodwill accounting model is used to test equity method goodwill for impairment.

C. Amortization

The unit of account for goodwill amortization (or the amortization of excess reorganization value) is the goodwill related to each acquisition (or the excess reorganization value related to each reorganization event).

If the goodwill alternative is elected, goodwill related to each acquisition is amortized on a straight-line basis over a period not to exceed 10 years. A private company may default to a 10-year amortization period (without justification) or choose to identify and use a shorter useful life if it can demonstrate that the shorter life is more appropriate. For example, if a private company acquires a target primarily to gain control of the target’s proprietary intellectual property, and the underlying patent for that intellectual property expires in seven years, it may be appropriate to use a useful life of seven years to amortize any related goodwill. It would rarely, if ever, be possible to demonstrate that a useful life of zero is appropriate.

If the facts and circumstances related to the useful life of a private company’s goodwill warrant a revision to that life, the private company may choose to (but does not have to) change the goodwill’s useful life. When a private company chooses to change the useful life of goodwill, it should ensure that the change will not result in a cumulative useful life for that goodwill in excess of 10 years. The effects of a change to the useful life of goodwill are accounted for prospectively.

D. Unit of account for impairment testing

If the goodwill alternative is elected, a private company must make an accounting policy election to test goodwill for impairment at the entity level or the reporting unit level. The definition of a reporting unit and the related guidance in the Codification has resulted in numerous practice issues for private companies over time. Some of these practice issues arise because the definition of a reporting unit has its origins in ASC 280, Segment Reporting, which is only directly applicable to public entities. Electing to perform goodwill impairment testing at the entity level under the goodwill alternative will save a private company from having to deal with these practice issues and the related costs. Additional information about assigning goodwill to reporting units is provided in Section 12.8 of our publication, A guide to accounting for business combinations (our business combinations guide).

E. Frequency of impairment testing

If the goodwill alternative is elected, goodwill should only be tested for impairment when a triggering event occurs. A triggering event is when events occur or circumstances change indicating that the fair value of the entity (or reporting unit) may be below its carrying amount (which includes goodwill). The occurrence of a triggering event draws into question whether the fair value of the entity (or reporting unit) may be below its carrying amount. ASC 350-20-35-3C provides many (but not all of the potential) examples of triggering events, including a deterioration in general economic conditions, an increased competitive environment, increases in the costs of raw materials or labor, negative or declining cash flows and changes in key personnel. This list is not all-inclusive, and an entity should consider other relevant events and circumstances that might affect the fair value or carrying amount of the entity (or reporting unit). Positive and mitigating events and circumstances also should be considered.

Identifying and evaluating a triggering event is a subjective practice requiring professional judgment and diligent documentation, and each private company should ensure it has the necessary processes and controls in place. A determination should be made at the end of each reporting period as to whether any
triggering events occurred during the reporting period. If one or more triggering events occurred, then the private company should test its goodwill for impairment.

**F. Impairment testing and recognition**

If the goodwill alternative is elected and one or more triggering events occur, a private company must test its goodwill for impairment. As part of that testing, a private company must first decide whether it will perform a qualitative assessment of whether its goodwill is impaired. If elected, the qualitative assessment requires the private company to answer the following question after considering all the relevant information available: Is it more likely than not that the fair value of the entity (or reporting unit) is less than the carrying amount of the entity (or reporting unit)? Each time a triggering event occurs, the private company can choose to perform or not perform the qualitative assessment. In other words, the private company’s decision to perform or not perform the qualitative assessment when a triggering event occurs does not predetermine what it will have to do the next time a triggering event occurs.

Spending the time and effort to perform a qualitative assessment is likely not justified from a cost-benefit perspective under the goodwill alternative, given that the performance of the goodwill impairment assessment was prompted by the private company concluding that the fair value of the entity (or reporting unit) may be below its carrying amount because a triggering event occurred. In other words, we believe it would be very unlikely that a private company would be able to conclude that it is not more likely than not that the fair value of the entity (or reporting unit) is less than its carrying amount (i.e., passing the qualitative assessment) after having just concluded that the fair value of the entity (or reporting unit) may be below its carrying amount (which was the outcome of the triggering event analysis that led to the goodwill impairment testing in the first place).

In the unlikely event that a private company opts to perform the qualitative assessment under the goodwill alternative and passes, the private company is finished with its impairment testing and no impairment is recognized. Otherwise, the private company must proceed to a quantitative assessment, which is also performed if the private company chooses not to perform the qualitative assessment. The quantitative assessment compares the fair value of the entity (or reporting unit) to its carrying amount (which includes goodwill). If the fair value of the entity (or reporting unit) is more than its carrying amount, no impairment is recognized. If the fair value of the entity (or reporting unit) is less than its carrying amount, then an impairment loss is recognized for the excess of the carrying amount over fair value. However, the amount of the impairment loss cannot be more than the carrying amount of the goodwill. Section F.1 discusses the consideration of deferred taxes under the goodwill alternative.

Under the goodwill alternative, if a goodwill impairment loss is recognized and the private company has goodwill from more than one acquisition on its books, the impairment loss should be allocated among the goodwill related to each acquisition using a reasonable and rational method. One such method allocates the impairment loss based on the carrying amount of each acquisition’s goodwill relative to the entity’s (or reporting unit’s) total goodwill. Another method might take into consideration whether the impairment loss could be attributed to a particular acquisition.

Recognition of a goodwill impairment loss establishes a new basis for the goodwill. It is not appropriate to reverse the impairment loss under any circumstances. The new basis in goodwill is amortized over its remaining useful life (see Section C). Consider a situation in which a private company amortizing goodwill over 10 years recognizes a goodwill impairment loss four years after the related acquisition. Once the impairment loss is recognized, the private company may choose to amortize the new basis in goodwill prospectively by: (a) using the remaining life of six years or (b) revising the useful life to something less than six years if more appropriate. Limiting a revised useful life to something less than six years ensures that the cumulative useful life for the goodwill does not exceed 10 years.
F.1 Deferred taxes

Under the goodwill alternative, deferred income taxes should be included in the carrying amount of the entity (or reporting unit) for those private companies subject to the provisions of ASC 740, *Income Taxes*. The inclusion of deferred income taxes in the carrying amount is *not* dependent on whether the fair value of the entity (or reporting unit) is measured assuming a taxable or nontaxable transaction.

ASU 2017-04 clarified that when a private company measures a goodwill impairment loss, it should consider how the deferred tax effects of that impairment affect the amount of impairment loss that should be recognized (as applicable) (see Section A.1 for discussion of the effective date for ASU 2017-04). As discussed in Section 11.4.5 of *our business combinations guide*, a deferred tax liability is not recognized when tax-deductible goodwill is less than goodwill for book purposes, but a deferred tax asset is recognized when tax-deductible goodwill is more than goodwill for book purposes. Determining the amount of the deferred tax asset to be recognized in this situation is not as simple as taking the difference in the tax and book bases of goodwill and multiplying it by the appropriate tax rate because goodwill is a residual.

Consider a situation in which a private company that has elected the goodwill alternative (and to test goodwill at the entity level) experiences a triggering event that requires it to test its goodwill for impairment. The carrying amount of the entity prior to measuring any goodwill impairment loss is $2,000 and its fair value is $1,800. Included in the entity’s carrying amount is $800 of goodwill (all of which is tax deductible) and a $400 deferred tax asset related to the excess of the tax-deductible goodwill over the goodwill for book purposes. Under the goodwill alternative, the private company preliminarily determines that an impairment loss of $200 should be recognized. The tax effects of that impairment loss (assuming a 30% tax rate) would increase the deferred tax asset by $60 ($200 additional basis difference × 30%) because recognition of the impairment for book purposes, but not for tax purposes, increases the amount by which tax-deductible goodwill exceeds goodwill for book purposes. Reducing goodwill by $200 and increasing deferred tax assets by $60 would result in an adjusted carrying amount for the entity of $1,860 ($2,000 – $200 + $60), which is still above the entity’s fair value of $1,800, indicating a larger impairment loss should be recognized. A simultaneous equation, such as the following one in ASC 805-740-55-10, may be used to calculate the additional deferred tax asset that should be recognized due to the impairment loss, and ultimately, the amount of loss that should be recognized for book purposes:

\[
\left(\frac{\text{Tax Rate}}{1 - \text{Tax Rate}}\right) \times \text{Preliminary Temporary Difference} = \text{Deferred Tax Asset}
\]

Using this equation, the additional deferred tax asset that should be recognized related to the impairment loss is $86 ([30% / (1 – 30%)] × $200), which results in a final impairment loss to be recognized of $286 ($200 + $86). To prove out the accuracy of these amounts, the tax effects of the increase in the amount by which the tax-deductible goodwill exceeds the adjusted amount of goodwill ($286 × 30% = $86) should be the same as the additional deferred tax asset recognized as a result of the impairment calculated using the simultaneous equation ($86).

G. Sequencing of impairment testing

If other assets have to be tested for impairment at the same time goodwill is being tested for impairment (because other applicable guidance in the Codification requires those assets to be tested for impairment), those other assets should be tested for impairment before goodwill is tested. For example, a triggering event that gives rise to testing goodwill for impairment under the goodwill alternative may also result in the private company having to test property, plant and equipment in accordance with ASC 360-10, *Property, Plant, and Equipment – Overall*. In that situation, the property, plant and equipment should be tested for impairment before the goodwill. Given the implications of this guidance, private companies should carefully consider whether the triggering event giving rise to the goodwill impairment test causes other assets of the entity (or reporting unit) (e.g., accounts receivable, inventory, equity method investments, intangible assets, property, plant and equipment) to be tested for impairment.
H. Derecognition

Under the goodwill alternative, when part of a private company is going to be disposed of, consideration should be given to whether any goodwill should be allocated to that part. If the part being disposed of meets the definition of a business, goodwill should be allocated to it using a reasonable and rational approach. The definition of a business used for this purpose is the same one used to determine whether a business was acquired (see Section 4.1 of our business combinations guide). When goodwill is allocated to a business to be disposed of, the allocated goodwill factors into the amount of gain or loss recognized upon disposal. If the part of the private company being disposed of does not meet the definition of a business, goodwill should not be allocated to it.

When the private company tests goodwill for impairment at the reporting unit level and the business being disposed of is only part of a reporting unit, ASC 350-20-40-1 to 40-6 should be referred to for guidance about what constitutes a reasonable and rational approach to allocating goodwill to the business. Given that this guidance discusses allocation of an impairment loss to part of a whole reporting unit, it should also be referred to for purposes of understanding what would be appropriate for purposes of allocating an impairment loss to part of a whole entity when impairment testing is performed at that level.

I. Presentation

A private company that elects the goodwill alternative must present goodwill net of accumulated amortization as a separate line item on its balance sheet. Income statement charges related to goodwill (i.e., amortization and impairment) should be included in income from continuing operations, unless the goodwill relates to a discontinued operation, in which case, the charges (net of tax) should be included in the results from discontinued operations. For those amounts included in income from continuing operations, there is no specific requirement to present them as a separate line item or within a specific line item.

For additional information about discontinued operations, refer to our white paper, Discontinued operations: Identification, presentation and disclosure.

J. Disclosure

A private company’s policy related to its accounting for goodwill should be disclosed in accordance with ASC 235-10-50. In addition, if a private company elects the goodwill alternative, it would also be required to disclose the nature and reason for the change in accounting principle in accordance with ASC 250.

When a private company elects the goodwill alternative, it is required to provide many of the same disclosures required under U.S. GAAP applicable to PBEs and other entities that have not elected the goodwill alternative. However, some incremental disclosure requirements would also apply. For example, the private company should disclose information related to the amortization of goodwill, including accumulated amortization, total amortization expense and the weighted-average amortization period for goodwill in total, as well as for each major business combination. Other disclosures related to goodwill and goodwill impairment losses also apply. Refer to ASC 350-20-50-4 to 50-7 for all of the disclosures required when a private company elects the goodwill alternative. While private companies that elect the goodwill alternative no longer have to disclose changes to goodwill in a tabular format, much of the information that was required to be included in the table is still otherwise required.

K. Effective date and transition

A private company is permitted to make a first-time election to apply the goodwill alternative at any time without having to perform a preferability assessment (as otherwise required by ASC 250). Private companies that elect the goodwill alternative should apply it prospectively to existing goodwill as of the beginning of the fiscal year of adoption and new goodwill recognized thereafter. For example, if a private
company decides to first elect the goodwill alternative in its 2021 calendar-year-end financial statements, it would adopt the alternative as of January 1, 2021. As such, amortization of any goodwill in existence on January 1, 2021, starts on that date (and absent any derecognition events, a full year of amortization expense should be recognized on that goodwill in 2021), and amortization of any new goodwill related to acquisitions in 2021 should begin on the acquisition date of the related business combination. In addition, for goodwill that exists as of the beginning of the fiscal year of adoption, a private company can default to amortizing it over a useful life of 10 years (without justification) on a straight-line basis, or it can choose to identify and use a shorter useful life if it can demonstrate that the shorter life is more appropriate.

### L. Considerations related to the election of the goodwill alternative

Before electing the goodwill alternative, a private company should carefully consider whether doing so makes sense in its facts and circumstances. For example, many of the anticipated benefits resulting from election of the goodwill alternative could be negated or offset if there is a reasonable possibility that the entity will go public or be acquired by a PBE in the future. If a private company goes public or is acquired by a PBE after it has elected the goodwill alternative, it would have to discontinue that election and retrospectively apply U.S. GAAP applicable to PBEs. In other words, the private company would have to retrospectively undo the accounting under the goodwill alternative. While ASC 250 provides relief to retrospective application of an accounting change when it is impracticable to do so, electing to apply the goodwill guidance in U.S. GAAP applicable to PBEs, although potentially challenging and costly, would rarely, if ever, be deemed impracticable.

To illustrate the consequences of discontinuing the election to apply the goodwill alternative, consider a situation in which a private company goes public three years after electing the goodwill alternative. To prepare historical financial statements to be included in its filings with the SEC, the private company will have to reverse goodwill amortization during the three years it applied the goodwill alternative and retroactively test its goodwill for impairment in each of those three years. While the reversal of goodwill amortization may not be time consuming, retroactive performance of goodwill impairment tests at a reporting unit level for those three years would likely be quite time consuming. In addition, the benefit of reduced financial reporting costs as a result of electing the goodwill alternative would be negated by the costs incurred to retroactively test goodwill for impairment. If there is a reasonable possibility that a private company may become a PBE in the future, and it still wants to adopt the private-company goodwill alternative, it may want to elect to test goodwill at a reporting unit level under the goodwill alternative to help simplify the potential transition.

A private company should discuss the effects of electing the goodwill alternative with the users of its financial statements to understand whether the private company’s election of the alternative is acceptable to those users. The users who should be considered in this regard include investors, lenders and regulators, among others. Thoughtful consideration also should be given to upcoming or potential changes in the users of its financial statements and the willingness of any potential new users of the financial statements to accept financial statements in which the goodwill alternative has been applied.