Simplified accounting for private companies: Goodwill

Prepared by:
Brian H. Marshall, Partner, National Professional Standards Group, RSM US LLP
brian.marshall@rsmus.com, +1 203 905 5014

January 2014 (updated April 2018)

TABLE OF CONTENTS

Background ...................................................................................................................................... 1
Scope ................................................................................................................................................ 1
Amortization measurement and recognition ................................................................................ 1
Impairment measurement and recognition ................................................................................... 2
  Sequencing of impairment testing .......................................................................................... 3
  Tax considerations ................................................................................................................... 3
Derecognition ................................................................................................................................... 3
Presentation ..................................................................................................................................... 4
Disclosure ........................................................................................................................................ 4
Effective date and transition .......................................................................................................... 4
Considerations before electing the accounting alternative ........................................................ 4
  Being acquired or going public ............................................................................................... 5
  Needs of financial statement users .......................................................................................... 5
Subsequent developments ............................................................................................................. 5
Background

On January 16, 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-02, Intangibles - Goodwill and Other (Topic 250): Accounting for Goodwill. This ASU, applicable to private companies, offers an accounting alternative that simplifies the subsequent accounting for goodwill. A private company electing the accounting alternative as its accounting policy will:

- Amortize goodwill over a period not to exceed 10 years (versus no amortization absent the alternative accounting election)
- Choose to test goodwill for impairment at either the entity level or the reporting unit level (versus at the reporting unit level absent the alternative accounting election)
- Test goodwill for impairment when a triggering event occurs (versus annually absent the alternative accounting election)
- Test and measure goodwill for impairment by comparing the entity’s (or reporting unit’s) fair value to its carrying amount (versus performing a two-step goodwill impairment test requiring hypothetical business combination accounting absent the alternative accounting election). See the section later on Subsequent developments.

If the accounting alternative is elected, all aspects of it must be elected. A private company cannot elect to apply the impairment guidance and not elect to apply the amortization guidance.

Prior to making the election, a private company should carefully consider the possibility of becoming, or being acquired by, a public business entity (PBE) in the future, and its acceptability to financial statement users, discussed later in the section, Considerations before electing the accounting alternative.

Scope

Private companies include entities other than the following: (a) those meeting the definition of a PBE or nonprofit entity as defined in the Master Glossary of the FASB’s Accounting Standards Codification (ASC) or (b) employee benefit plans that fall within the scope of the related topics in the ASC (Topics 960, 962 and 965). The FASB recently issued ASU 2013-12, Definition of a Public Business Entity: An Addition to the Master Glossary, adding the definition of a PBE to the ASC. The definition of a PBE is broader than the terms public entity and publicly traded company used through the ASC. A private company should give careful consideration in determining whether it meets the new definition. For additional information, refer to our article, Definition of a public business entity: Additional guidance.

If elected, the accounting alternative applies to all new and existing goodwill. An entity cannot choose to apply the accounting alternative to goodwill related to some acquisitions and not to others. The accounting alternative also applies to the excess reorganization value that may arise in applying fresh-start reporting as described in ASC 852 and equity method goodwill, a component of an investor’s equity method investment. If the accounting alternative is elected, an investor will include amortization of equity method goodwill in equity method income or loss. However, consistent with current guidance, equity method goodwill is not tested for impairment separately from the overall equity method investment. In other words, neither the accounting alternative nor the legacy goodwill accounting model is used to test equity method goodwill for impairment.

Amortization measurement and recognition

If the accounting 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 is permitted to default to a 10-year amortization period (without justification) or use a shorter useful life if it can demonstrate that a 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 most appropriate to amortize goodwill over seven years. A useful life of zero would rarely, if ever, be appropriate.

If facts and circumstances indicate that a recorded goodwill’s useful life warrants revision, the private company may choose to (but does not have to) revise the amortization period. If revised, a private company should ensure that the change will not result in a cumulative useful life for that goodwill in excess of 10 years. For example, assume 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 would recognize the new basis in goodwill prospectively over the remaining life of six years. If the private company chooses to revise the goodwill asset’s useful life, it is restricted to a term of six years or less due to the ten year limit.

**Impairment measurement and recognition**

If the accounting 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 ASC 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 accounting alternative will save a private company from having to deal with these practice issues and the related costs.

Upon election of the accounting alternative, goodwill should be tested for impairment if an event occurs or circumstances change indicating that the entity’s fair value (or the reporting unit’s fair value) may be below its carrying amount. A change in event or circumstances is termed a **triggering event**. When a triggering event occurs, the entity will assess whether it is more likely than not (a likelihood of more than 50 percent) that the fair value of the entity (or reporting unit) may be below its carrying amount, including goodwill. ASC 350-20-35-3C provides example triggering events, including deterioration in general economic conditions, an increased competitive environment, increase in the costs of raw materials or labor, negative or declining cash flows and changes in key personnel. The 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 even 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 period.

Upon the occurrence of a triggering event, a private company may perform a qualitative assessment of whether its goodwill is impaired, but has an unconditional option not to. A private company’s decision to not perform a qualitative assessment when a triggering event occurs has no effect on whether it will perform a qualitative assessment in the future.

Spending the time and effort to perform a qualitative assessment is likely not justified from a cost-benefit perspective under the accounting 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).
If a qualitative test is performed and the results indicate that a quantitative test is necessary, or a qualitative test is not performed, the private company should perform a quantitative impairment test. The quantitative assessment compares the fair value of the entity (or reporting unit) to its carrying amount, including goodwill. An entity will recognize an impairment charge for the amount by which the carrying amount, including goodwill, exceeds fair value. The impairment charge cannot exceed the carrying amount of goodwill allocated to the entity (or reporting unit).

A private company with goodwill resulting from more than one acquisition will allocate the impairment loss to the entity (or reporting unit’s) amortizable units of goodwill on a pro-rata basis or other reasonable and rational basis. An impairment loss attributed to one or more specific acquisitions could be allocated to those identified amortizable units of goodwill. Recognition of a goodwill impairment loss establishes a new basis for the goodwill to be amortized over its remaining useful life. It is not appropriate to reverse the impairment loss under any circumstances.

A goodwill impairment loss associated with a discontinued operation should be included (net-of-tax) within the results of discontinued operations. A business, on acquisition, meeting the criteria in ASC 205-20-45 to be classified as held for sale is a discontinued operation. ASU 2014-08 contains several examples on how to interpret the definition of discontinued operation. For more insights on discontinued operations, refer to our paper, Discontinued operations: Identification, presentation and disclosure.

**Sequencing of impairment testing**

For situations in which other assets are tested for impairment in the same period as goodwill is tested, 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 accounting alternative may also result in the private company having to test property, plant and equipment for impairment 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 likely requires other assets (e.g., accounts receivable, inventory, equity method investments, property, plant and equipment) of the entity (or reporting unit) to be tested for impairment.

**Tax considerations**

ASU 2017-04, discussed later in the Subsequent developments section, clarifies guidance for private companies with tax deductible goodwill. In measuring a goodwill impairment loss, an entity should include the income tax effects of tax deductible goodwill in the carrying amount of the entity (or reporting unit). 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. The amendments in ASU 2017-04 are effective at the same time as ASU 2014-02, discussed later in the Effective date and transition section, with early adoption permitted. Recognition of an impairment loss could increase the deferred tax assets (or decrease the deferred tax liabilities) such that the carrying amount of the entity (or reporting unit) initially exceeds the fair value of the entity (or reporting unit). Refer to ASC 350-20-35-8B for further discussion of the appropriate calculation of the impairment loss in this scenario using the simultaneous equations method.

**Derecognition**

Under the accounting alternative, if a portion of a private company meeting the definition of a business is disposed of, goodwill should be allocated to it using a reasonable and rational approach. The goodwill allocation will affect the gain or loss recognized on disposal. If the private company tests goodwill for impairment at the reporting unit level, the guidance in ASC 350-20-40 through 6 generally represents a reasonable and rational approach for allocating goodwill. If the portion of the entity being disposed of does not meet the definition of a business, goodwill should not be allocated to it. ASU 2017-01, Clarifying
the Definition of a Business, adds guidance to assist entities with evaluating whether an integrated set of assets and activities should be accounted for as acquisitions or disposals of a business. The guidance is expected to result in fewer transactions being treated as a disposal of a business, particularly in the real estate industry. For private companies, the new guidance is effective for annual periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2019. Early adoption is permitted. Refer to our article, Business combinations: Clarifying the definition of a business, for more information.

Presentation

Private companies electing the accounting alternative must present goodwill net of accumulated amortization and impairment as a separate line item on its balance sheet. Amortization and impairment charges should be included in income from continuing operations, with the exception of goodwill related to a discontinued operation. Impairment charges related to a discontinued operation should be included in results from discontinued operations, net of tax. No requirement exists to present amounts included in income from continuing operations as a separate line item or within a specific line item.

Disclosure

A private company electing the accounting alternative is required to describe the nature and reason for the change in accounting principle, according to Topic 250, Accounting Changes and Error Corrections. The goodwill disclosure requirements are generally consistent with current guidance, with new disclosures added. For example, a private company would be required to disclose accumulated amortization, total amortization expense and the weighted-average amortization period for aggregate goodwill, as well as goodwill attributed to each major business combination, among other disclosures. While a private company electing the accounting alternative is no longer required to disclose changes to goodwill in a tabular format, much of the information required to be included in the table would still require disclosure. Refer to ASC 350-20-50-4 through 7 for a discussion of disclosure requirements.

Effective date and transition

In 2016, the FASB issued ASU 2016-03, Intangibles - Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance (a consensus of the Private Company Council). ASU 2016-03 removes the effective dates of ASU 2014-02 and the other three private company ASUs issued in 2014. ASU 2016-03 allows a private company to elect the goodwill accounting alternative in any future accounting period without establishing preferability under Topic 250, Accounting Changes and Error Corrections. ASU 2016-03 also eliminates the requirement for a private entity electing a private company accounting alternative to retrospectively apply a change in accounting principle to all periods presented—a requirement under Topic 250 generally applicable to accounting changes.

Regarding transition, the amendments in ASU 2016-03 indefinitely extend the transition guidance in all private company alternatives. For the goodwill alternative in ASU 2016-03, elimination of its effective dates and extension of its prospective transition guidance means that a private company voluntarily electing to adopt ASU 2014-02 will prospectively apply the standard to existing goodwill as of the beginning of the fiscal year of adoption and new goodwill recognized thereafter.

Considerations before electing the accounting alternative

A private company should carefully consider whether electing the accounting alternative makes sense considering its own unique facts and circumstances and recent FASB activities. Factors to consider include:
Being acquired or going public

If a private company concludes that it is eligible to elect the accounting alternative, it should consider whether a reasonable possibility exists that it may go public or be acquired by a PBE. The definition of a PBE, which is integral to determining which entities can apply the accounting alternative, is broader than the terms generally used to consider an entity public.

An entity may meet the definition of a PBE solely because its financial statements or financial information are required to be included in a filing with the SEC, such as under Regulation S-X, Rule 3-09, Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons, or Regulation S-X, Rule 3-05, Financial Statements of Businesses Acquired or to Be Acquired, and Regulation S-X, Rule 4-08(g), Summarized Financial Information. When an entity’s financial statements are required to be included in a filing with the SEC, they must be prepared using the same accounting principles as a PBE. In situations where a private company has elected an accounting alternative, this means the private company’s financial statements would need to be retrospectively adjusted to unwind the effects of goodwill recognition and measurement under the private company alternative. If a private company’s financial statement meet the requirements to be included in an SEC filing, the entity is included in the scope of a PBE only for purposes of financial statements filed or furnished with the SEC. The entity would not be considered a PBE for purposes of its standalone financial statements not filed or furnished with the SEC. For additional information about the new definition, refer to our article, Definition of a public business entity: Additional guidance.

Pending any upcoming transition guidance from the FASB and SEC staff members, a private company that elects the accounting alternative and later becomes a PBE would be required to retrospectively apply the change in accounting principle to all periods presented. While ASC 250 provides relief to retrospective application when it is impracticable to do so, restating the financial statements to apply the legacy goodwill accounting model, although potentially challenging and costly, would rarely, if ever, be deemed impracticable. Private companies should also take into consideration that the issuance of ASU 2017-04, discussed later, provides simplification amendments to goodwill impairment testing to all entities. If the private company alternative is elected and a reasonable possibility exists that the private company may become a PBE, it may be best to test goodwill at a reporting unit level (required for PBEs) to simplify restating prior periods if an acquisition comes to fruition or it becomes a PBE.

Needs of financial statement users

A private company should discuss the effects of electing the accounting alternative with its financial statement users and, as possible, obtain confirmation that its financial statements under the new goodwill accounting method are acceptable. Vested parties to consider include investors, lenders and regulators, among others. Thoughtful consideration also should be given to upcoming or potential changes in vested parties and their willingness to accept financial statements that differ from those prepared by a PBE.

A private company electing the accounting alternative in ASU 2014-18, Accounting for Identifiable Intangible Assets in a Business Combination (a consensus of the Private Company Council), is required to adopt ASU 2014-02, and, hence, the effects of these changes should be considered in the aggregate. Refer to our article, Simplified accounting for private companies: Certain intangible assets, for the accounting effects of adopting ASU 2014-18.

Subsequent developments

In 2017, the FASB issued ASU 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment, to simplify the goodwill impairment model for PBEs and other entities reporting goodwill in its financial statements that have not elected the private company alternative for the subsequent measurement of goodwill under ASU 2014-02. Like the provisions in ASU 2014-02, ASU 2017-04 replaces legacy Step 2 (the application of hypothetical business combination accounting) from
the goodwill impairment model. A simpler, one-step impairment test, performed when a triggering event occurs, compares the fair value of a reporting unit with its carrying amount. Recognition of an impairment loss, if any, is limited to the carrying amount of goodwill. If the reporting unit has a zero or negative carrying amount, no goodwill impairment is recognized.

Unlike the amendments in ASU 2014-02, ASU 2017-04 is not elective for PBEs and other entities that have not elected the private company alternative for the subsequent measurement of goodwill. SEC filers must adopt ASU 2017-04 for fiscal years beginning after December 15, 2019, provided earlier implementation is not elected. Non-SEC filers should adopt the amendments in annual periods beginning after December 15, 2020 and interim periods within those annual periods. All other entities are required to adopt the amendments for fiscal years beginning after December 15, 2021 and interim periods within those years. Early adoption is permitted for interim or annual periods beginning after January 1, 2017.

Private companies that have adopted the private company goodwill impairment alternative, but not the private company alternative to subsume certain intangible assets into goodwill, are permitted to (but not required to) adopt ASU 2017-04. A private company will not have to justify preferability of the accounting change following the guidance in FASB ASC Topic 250, Accounting Changes and Error Corrections, if adoption occurs on or before ASU 2017-04’s effective date. Private companies that have adopted the private company alternative to subsume certain intangible assets into goodwill, and, thus, have also adopted the goodwill impairment alternative, are not permitted to adopt ASU 2017-04 without following the guidance in Topic 250, which includes justifying why adoption of ASU 2017-04 is preferable to ASU 2014-02 and retrospectively restating its financial statements.

For additional information about the accounting alternative and assistance in the evaluation of your specific facts and circumstances, contact your RSM professional.