SIMPLIFYING THE TEST FOR GOODWILL IMPAIRMENT

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Overview

Accounting for the impairment of goodwill under legacy guidance can be complex and costly. The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, to simplify the goodwill impairment model applicable to public business entities (PBEs) and other entities that have goodwill reported in their financial statements and have not elected the private company goodwill impairment alternative. This white paper provides information about various provisions in the ASU as well as the effective date and transition information.

The simplifications provided in the ASU include:

- 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

The elimination of Step 2 from the goodwill impairment model removes the cost and complexity often associated with that step, which required measuring the goodwill impairment charge by determining the fair value of assets and liabilities (including unrecognized assets and liabilities) in the reporting unit. This simplification does not affect an entity's ability to first perform a qualitative assessment of whether it is more likely than not (a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount.

While these simplifications also eliminate the current requirement to perform a qualitative assessment of whether goodwill is impaired when the reporting unit has a zero or negative carrying amount, an entity that has one or more reporting units with zero or negative carrying amounts must disclose the goodwill allocated to each of those reporting units.

The FASB also provided guidance regarding the treatment of deferred taxes when applying the private company goodwill impairment alternative.

Entities should apply the changes in the ASU on a prospective basis, and certain disclosures will be required. Additional transition guidance is provided for those private companies that have elected the private company goodwill impairment alternative but choose to adopt the simplified goodwill impairment model in ASU 2017-04.

A PBE that is a Securities and Exchange Commission (SEC) filer should adopt the amendments in ASU 2017-04 for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. A PBE that is not an SEC filer should adopt the amendments for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020. All other entities, including not-for-profit entities that are adopting the amendments, should do so for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates on or after January 1, 2017.

RSM commentary: We expect that many entities who would be required to perform Step 2 under the existing goodwill impairment model will early adopt the ASU to take advantage of the simplifications.

Main provisions

Scope

The amendments in ASU 2017-04 are required for PBEs and other entities that have goodwill reported in their financial statements and have not elected the private company goodwill impairment alternative. Companies that have adopted the private company goodwill impairment alternative may be able to adopt ASU 2017-04 following the guidance summarized later in this white paper.

What has not changed

The ASU does not change the following legacy guidance for the accounting for the impairment of goodwill:

- Goodwill is not amortized.
- A goodwill impairment test is required at least annually, and an interim impairment test is necessary if certain triggers are present.
- The unit of account to be used in testing goodwill is the reporting unit.
- An entity has the option of performing the qualitative assessment for a reporting unit to determine whether the quantitative impairment test is necessary.
- An entity has the unconditional option to bypass the qualitative assessment and proceed directly to performing the quantitative goodwill test.
- When the quantitative goodwill impairment test is used, the fair value and the carrying value of each reporting unit must be determined.

What has changed

The ASU simplifies how an entity is required to test goodwill for impairment by eliminating Step 2 from the quantitative test. Legacy guidance required potential goodwill impairment to be measured in Step 2 as the amount by which the carrying value of goodwill exceeded the implied fair value of that goodwill. In computing the implied fair value of goodwill under Step 2, an entity had to perform procedures to determine the fair value at the impairment testing date of its assets and liabilities (including unrecognized assets and liabilities) following the procedure that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. Instead, under the ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, income tax effects from tax deductible goodwill must be considered when measuring the goodwill impairment loss, if applicable.

The FASB also eliminated the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. Therefore, the same impairment assessment applies to all reporting units. An entity is required to disclose the goodwill allocated to each reporting unit with a zero or negative carrying amount of net assets.

RSM commentary: Since a positive fair value of a reporting unit, no matter how small, always will be higher than a zero or negative carrying amount, such reporting units will generally not have goodwill impairment.

The ASU also eliminated the provision that allowed a best estimate of goodwill impairment to be recognized if the goodwill impairment test is not complete before the financial statements are issued or

available to be issued. Thus, the goodwill impairment test now must be complete before issuing the financial statements.

Other provisions

Adoption by companies following private company goodwill impairment alternative

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, but not required, to adopt ASU 2017-04 without having to justify preferability of the accounting change if it is adopted on or before the effective date. Private companies that have adopted the private company alternative to subsume certain intangible assets into goodwill, and, thus, also adopted the goodwill impairment alternative, are not permitted to adopt the guidance upon issuance without following the guidance in FASB Accounting Standards Codification (ASC) Topic 250, *Accounting Changes and Error Corrections*, including justifying why it is preferable to change their accounting policies.

Deferred income tax considerations

As indicated in ASC 350-20-35-8B, "If a reporting unit has tax deductible goodwill, recognizing a goodwill impairment loss may cause a change in deferred taxes that results in the carrying amount of the reporting unit immediately exceeding its fair value upon recognition of the loss. In those circumstances, the entity shall calculate the impairment loss and associated deferred tax effect in a manner similar to that used in a business combination in accordance with the guidance in paragraphs 805-740-55-9 through 55-13. The total loss recognized shall not exceed the total amount of goodwill allocated to the reporting unit." The following example from ASC 350-20-55-23A through 55-23D illustrates this calculation:

> Goodwill is deductible for tax purposes for some business combinations in certain jurisdictions. In those jurisdictions, a deferred tax asset or deferred tax liability is recorded upon acquisition on the basis of the difference between the book basis and the tax basis of goodwill. When goodwill of a reporting unit is tax deductible, the impairment of goodwill creates a cycle of impairment because the decrease in the book value of goodwill increases the deferred tax asset (or decreases the deferred tax liability) such that the carrying amount of the reporting unit increases. However, there is no corresponding increase in the fair value of the reporting unit and this could trigger another impairment test.
>
> This Example illustrates the use of a simultaneous equation when tax deductible goodwill is present to account for the increase in the carrying amount from the deferred tax benefit.
>
> Beta Entity has goodwill from an acquisition in Reporting Unit X. All of the goodwill allocated to Reporting Unit X is tax deductible. On October 1, 20X6 (the date of the annual impairment test for the reporting unit), Reporting Unit X had a book value of goodwill of $400, which is all tax deductible, deferred tax assets of $200 relating to the tax-deductible goodwill, and book value of other net assets of $400. Reporting Unit X is subject to a 40 percent income tax rate. Beta Entity estimated the fair value of Reporting Unit X at $900.

	Carrying Amount	Fair Value	Preliminary Impairment	Preliminary Deferred Tax Adjustment	Carrying Amount after Preliminary Impairment
Goodwill	$ 400	$ -	$ (100)	$ -	$ 300
Deferred taxes	200	-	-	40	240
Other net assets	400	-	-	-	400
Total	$ 1,000	$ 900	$ (100)	$ 40	$ 940

> In the Example above, the carrying amount of Reporting Unit X immediately after the impairment charge exceeds its fair value by the amount of the increase in the deferred tax asset calculated as 40 percent of the impairment charge. To address the circular nature of the carrying amount exceeding the fair value, instead of continuing to calculate impairment on the excess of carrying amount over fair value until those

amounts are equal, Beta Entity would apply the simultaneous equation demonstrated in paragraphs 805-740-55-9 through 55-13 to Reporting Unit X, as follows.

Simultaneous equation: [tax rate/(1 – tax rate)] × (preliminary temporary difference) = deferred tax asset

Equation for this example: 40%/(1 – 40%) × 100 = 67

	Carrying Amount	Fair Value	Preliminary Impairment	Adjustment for Equation	Carrying Amount after Impairment
Goodwill	$ 400	$ -	$ (100)	$ (67)	$ 233
Deferred taxes	200	-	-	67	267
Other net assets	400	-	-	-	400
Total	$ 1,000	$ 900	$ (100)	$ 0	$ 900

The company would report a $167 goodwill impairment charge partially offset by a $67 deferred tax benefit recognized in the income tax line. If the impairment charge calculated using the equation exceeds the total goodwill allocated to a reporting unit, the total impairment charge would be limited to the goodwill amount.

Assignment of assets and liabilities to a reporting unit

The ASU clarified an issue related to assigning acquired assets and assumed liabilities to a reporting unit by adding paragraph 350-20-35-39A as follows:

> Foreign currency translation adjustments should not be allocated to a reporting unit from an entity's accumulated other comprehensive income. The reporting unit's carrying amount should include only the currently translated balances of the assets and liabilities assigned to the reporting unit.

Amendment to private company goodwill impairment alternative

The ASU added a provision related to the private company goodwill impairment alternative by stating in paragraph 350-20-35-73 that:

> …Additionally, an entity shall consider the income tax effect from any tax deductible goodwill on the carrying amount of the entity (or the reporting unit), if applicable, in accordance with paragraph 350-20-35-8B when measuring the goodwill impairment loss…

For additional information regarding deferred income tax considerations, see the preceding guidance in this white paper.

Disclosures

An entity is required to disclose the nature of and reason for the change in accounting principle upon transition. That disclosure should be provided in the first annual period and in the interim period within the first annual period when the entity initially adopts the ASU. Further, entities with one or more reporting units with zero or negative carrying amounts must disclose the goodwill allocated to each of those reporting units and the reportable segment the reporting unit is included within.

Effective date and transition

The changes to the goodwill impairment models will have the following staggered effective dates:

- PBEs that are SEC filers: Fiscal years beginning after December 15, 2019, including interim periods within those years (January 1, 2020 for calendar year-end entities)
- PBEs other than SEC filers: Fiscal years beginning after December 15, 2020, including interim periods within those years (January 1, 2021 for calendar year-end entities)
- All other entities: Fiscal years beginning after December 15, 2021, including interim periods within those years (January 1, 2022 for calendar year-end entities)

All entities are permitted to early adopt the changes to the goodwill impairment models for interim or annual goodwill impairment tests performed on testing dates on or after January 1, 2017.

The amendments in the ASU should be applied prospectively on or after the effective date.

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