

To the Point

FASB – final guidance

FASB simplifies the accounting for goodwill impairment

Entities will no longer have to perform Step 2 of the goodwill impairment test.

What you need to know

- ▶ The FASB issued new guidance that eliminates the requirement to calculate the implied fair value of goodwill (i.e., Step 2 of today's goodwill impairment test) to measure a goodwill impairment charge.
- ▶ Instead, entities will record an impairment charge based on the excess of a reporting unit's carrying amount over its fair value (i.e., measure the charge based on today's Step 1).
- ▶ The standard has tiered effective dates, starting in 2020 for calendar-year public business entities that meet the definition of an SEC filer. Early adoption is permitted for annual and interim goodwill impairment testing dates after 1 January 2017.

Overview

The Financial Accounting Standards Board (FASB or Board) issued final guidance¹ that simplifies the accounting for goodwill impairment for all entities by requiring impairment charges to be based on the first step in today's two-step impairment test under Accounting Standards Codification (ASC) 350.²

The FASB added this project to its agenda in response to feedback it received in 2014, when it issued an accounting alternative developed by the Private Company Council (PCC) that allows private companies to amortize goodwill and use a simpler one-step impairment test.³ At the time, the FASB asked whether it should allow other entities to apply the guidance in the alternative, and stakeholders expressed concerns about the cost and complexity of subsequently measuring goodwill for all entities.

Under today's guidance, if the fair value of a reporting unit is lower than its carrying amount (Step 1), an entity calculates any impairment charge by comparing the implied fair value of goodwill with its carrying amount (Step 2). The implied fair value of goodwill is calculated by deducting the fair value⁴ of all assets and liabilities of the reporting unit from the reporting unit's fair value as determined in Step 1. To determine the implied fair value of goodwill, entities estimate the fair value of any unrecognized intangible assets (including in-process research and development) and any corporate-level assets or liabilities that were included in the determination of the carrying amount and fair value of the reporting unit in Step 1. All of this makes Step 2 costly and complex.

Key considerations

Under the new guidance, if a reporting unit's carrying amount exceeds its fair value, an entity will record an impairment charge based on that difference. The impairment charge will be limited to the amount of goodwill allocated to that reporting unit. The standard eliminates today's requirement to calculate a goodwill impairment charge using Step 2 as described above.

The standard does not change the guidance on completing Step 1 of the goodwill impairment test. An entity will still be able to perform today's optional qualitative goodwill impairment assessment before determining whether to proceed to Step 1. In addition, private companies will still have the option to elect the PCC alternative on goodwill.

Tax-deductible goodwill

Goodwill amortization is deductible for tax purposes in certain jurisdictions. If that's the case, recognizing a goodwill impairment charge would increase a deferred tax asset or decrease a deferred tax liability. Either change would result in the carrying amount of the reporting unit immediately exceeding its fair value, which would require another impairment charge. To address this issue, the new guidance requires an entity to calculate the impairment charge and the deferred tax effect using a simultaneous equations method that is similar to how an entity measures goodwill and related deferred tax assets in a business combination.

For example, assume an entity has a reporting unit with \$100 in book value of goodwill that is all tax deductible, and the entity has a tax rate of 40%. If the carrying amount of the reporting unit is \$500 and its fair value is \$450, the entity would initially identify a goodwill impairment charge of \$50 before considering the effect of deferred taxes using the simultaneous equations method. If the guidance didn't require the simultaneous equations method, the deferred tax effect of the goodwill impairment would be \$20 ($\$50 \times 40\%$), and the subsequent carrying value of the reporting unit would be \$470 ($\$500 - \$50 + \20). Because there would be no corresponding increase in the fair value of the reporting unit, the reporting unit would have another impairment of \$20 ($\$450 - \470). Thus, the deferred tax effect would result in a continuous cycle of impairment.

When the simultaneous equations method is used, the entity would calculate a goodwill impairment charge of \$83 as follows: $\$50 + [(40\% / (1 - 40\%)) \times \$50]$.⁵ This effectively grosses up the goodwill impairment charge to account for the increase of \$33 in the deferred tax asset related to the tax-deductible goodwill so that after the entity records the goodwill impairment charge and the deferred tax effect, the carrying value ($\$500 - \$83 + \$33$) and the fair value ($\450) of the reporting unit are equal.

How we see it

Entities will need to consider the deferred tax effect only when goodwill assigned to the reporting unit is tax deductible and the reporting unit's carrying value exceeds its fair value. Entities will need to carefully evaluate the tax attributes of goodwill assigned to reporting units when calculating the amount of goodwill impairment.

Reporting units with zero or negative carrying amounts

Today, entities that have reporting units with zero or negative carrying amounts perform a qualitative assessment to determine whether to perform Step 2 of the goodwill impairment test. Under the standard, entities with these reporting units will no longer be required to perform the qualitative assessment. As a result, reporting units with zero or negative carrying amounts will generally be expected to pass the simplified impairment test.

However, those entities will have to identify any reporting units with zero or negative carrying amounts with goodwill and disclose the amount of goodwill allocated to each. An entity also will be required to disclose which reportable segment the reporting unit is included in.

How we see it

The standard may increase the frequency of goodwill impairment charges. Under today's guidance, it is possible for a reporting unit to fail Step 1 but for goodwill not to be impaired, based on how impairment is measured in Step 2.

Eliminating Step 2 of today's test could increase the frequency of goodwill impairment.

Transition and effective date

The standard will be applied prospectively and is effective for annual and interim impairment tests performed in periods beginning after:

- ▶ 15 December 2019, for public business entities (PBEs) that meet the definition of a Securities and Exchange Commission (SEC) filer (i.e., for any impairment test performed by calendar-year entities in 2020)
- ▶ 15 December 2020, for PBEs that are not SEC filers (i.e., for any impairment test performed by calendar-year entities in 2021)
- ▶ 15 December 2021, for all other entities (i.e., for any impairment test performed by calendar-year entities in 2022)

Early adoption is permitted for annual and interim goodwill impairment testing dates after 1 January 2017.

The effective dates generally align with those the FASB set for the new credit losses standard⁶ it issued last year. The Board aligned the dates to reduce the risk of double counting losses that might have occurred if banks and other entities with significant financial instruments had to adopt the goodwill standard before adopting the new guidance on credit losses. For example, assume a bank adopts the goodwill standard before adopting the credit loss standard. It could record a goodwill impairment charge if a decrease in the fair value of its loan portfolio resulted in the carrying amount of the reporting unit as a whole exceeding its fair value. The bank could then have to record a charge for loan impairment when it adopts the credit loss standard and records the lifetime expected credit losses associated with those loans.

Aligning the effective dates of the two standards will allow an entity to first adjust the carrying amount of its loan portfolios (and, therefore, the carrying amount of the associated reporting unit) before testing for goodwill impairment.

How we see it

- ▶ We expect many entities will early adopt the goodwill impairment standard if they would be required to perform Step 2 under today's guidance. However, we believe entities should evaluate the effect of adopting the new credit loss standard prior to making this decision.
- ▶ Entities with reporting units that failed Step 1 but passed Step 2 of today's goodwill impairment test will likely need to perform an interim impairment test at the beginning of the period of adoption.

Other considerations

The standard also amends the overview and background sections of ASC 350 as part of the Board's separate initiative to unify and improve these sections in all of its guidance. This includes amendments to sections unrelated to the accounting for goodwill impairment (i.e., internal-use software, other intangibles). These amendments are not intended to change the application of the guidance in ASC 350.

Endnotes:

- ¹ Accounting Standards Update (ASU) 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*.
- ² ASC 350, *Intangibles – Goodwill and Other*.
- ³ ASU 2014-02, *Intangibles – Goodwill and Other (Topic 350): Accounting for Goodwill* (a consensus of the Private Company Council).
- ⁴ For the purposes of calculating the implied fair value of goodwill, the assets and liabilities are measured at fair value (with limited exceptions) in accordance with ASC 805, *Business Combinations*, as if the reporting unit had been acquired in a business combination.
- ⁵ Simultaneous equations method to calculate goodwill impairment charge: Excess of reporting unit carrying value over fair value + [(Tax rate / 1- tax rate) x Excess of reporting unit carrying value over fair value].
- ⁶ ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.

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