CURRICULUM: Accounting and Auditing

LEVEL: Basic

DESIGNED FOR: CPAs who work for or with public business entities and other entities, and private companies

OBJECTIVES: To compare the new simplified guidance with the current guidance, including FASB's interim responses to concerns over cost and complexity, and explore Board concerns about outcomes from the simplified test

KEY TOPICS: Quantitative and qualitative tests; impairment loss calculation; FASB responses to cost and complexity concerns; private company alternative; new guidance; tax deductible goodwill; reporting units with zero or negative book values; effective dates; and future phase

PREREQUISITES: None

ADVANCED PREPARATION: None

FASB Simplifies the Test for Goodwill Impairment

By JANE N. BALDWIN, PH.D.

In May 2014, the Financial Accounting Standards Board (FASB) announced a simplification initiative to reduce the costs and complexity of generally accepted accounting principles (GAAP). Among the projects completed under this initiative is the simplification of the goodwill impairment test (ASU 2017-04).

This article will compare the new simplified guidance with the current guidance, including FASB's interim responses to concerns over cost and complexity. In addition, the article will explore the serious concerns that some of the Board members had over possible outcomes from the simplified test.

Current Guidance for Identifying Goodwill Impairment

Under current GAAP for public companies, goodwill is not amortized, but is tested at least annually for impairment. The test includes two steps with the option for the entity to first assess qualitative factors (such as a deterioration in general economic conditions or an increased competitive environment) to determine whether it is more likely than not that the fair value of a reporting unit is less than its book value, including goodwill (sometimes referred to as Step 0).

If the company determines that it is more likely than not that the fair value of a reporting unit is less than its book value, then it will proceed with the quantitative test.

Step 1. Quantitative Test – Fair Value Test on Reporting Unit as a Whole

The first step of the goodwill impairment test compares the fair value of a reporting unit to its book value, including goodwill. If the fair value of a reporting unit exceeds its book value, the goodwill of the reporting unit is considered not impaired. If the book value of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss.

Step 2. Impairment Loss Calculation – Fair Value Test on Goodwill

A company recognizes an impairment loss for the amount by which the book value of the goodwill of a reporting unit exceeds the implied fair value of that goodwill. Because the fair value of goodwill can be measured only as a residual and not directly, an implied fair value is calculated as the difference between the fair value of the reporting unit as a whole less the fair value of the company's individual assets and liabilities, including any unrecognized intangible assets (excluding goodwill) as if the company had been acquired in a business combination.

The process of assigning a fair value to all of the individual assets, liabilities and unrecognized non-goodwill intangibles is costly and complex. Please see Figure 1 for Step 1 and Step 2.

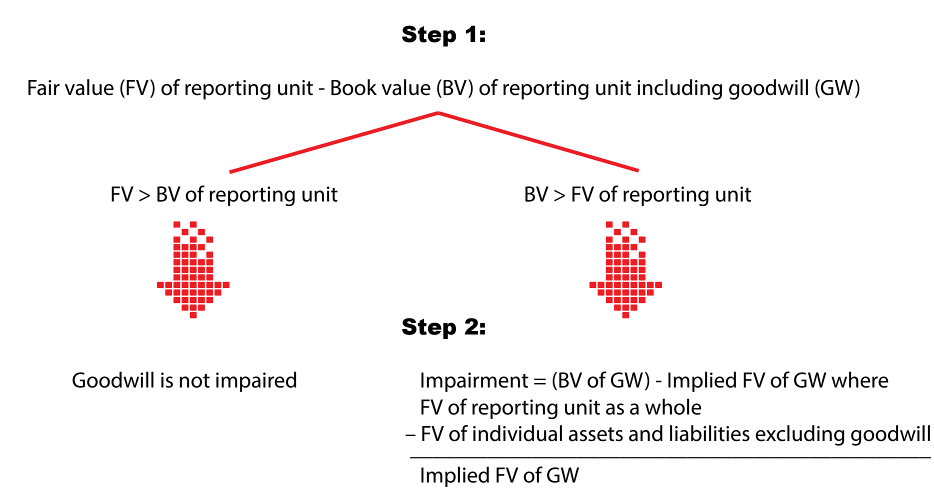
FASB's Interim Responses to Concerns About Cost and Complexity

Since the 2001 issuance of Statement of Financial Accounting Standards No. 142 – *Goodwill and Other Intangibles,* FASB has received input from preparers indicating concerns over the cost and complexity of the annual two-step impairment test. Prior to ASU 2017-04, FASB issued two updates to the original statement to address cost and complexity.

Qualitative Test (ASU 2011-8)

FASB's update in 2011 provides the optional qualitative assessment (FASB, 2011). If the company finds, based on qualitative factors, that it is more likely than not that the fair value of a reporting unit is not less than its book value, it does not have to proceed with the costly quantitative test. However, a 2013 goodwill impairment study (Tysiac, 2013) found that just 29 percent of public companies and 22 percent of private companies participating used the qualitative assessment, citing the cost of the qualitative assessment and the greater confidence in their conclusions with the quantitative test.

FIGURE 1: Current Guidance for Identifying Goodwill Impairment



Private Company Alternative (ASU 2014-02)

In 2014, FASB provided an alternative treatment of goodwill for private companies that elect it (FASB, 2014). In ASU 2014-02, FASB makes the following observation regarding the cost and benefit of the earlier guidance for subsequent measurement of goodwill for private companies.

During its research and outreach efforts on this issue, the PCC (Private Company Council) obtained feedback from private company stakeholders that the benefits of the current accounting for goodwill after initial recognition do not justify the related costs. Feedback from users of private company financial statements indicated that the goodwill impairment test performed today provides limited decision-useful information, because most users of private company financial statements generally disregard goodwill and goodwill impairment losses in their analysis of a private company's financial condition and operating performance. The PCC also received input from preparers and auditors of private company financial statements indicating concerns about the cost and complexity involved in performing the current goodwill impairment test. Private company stakeholders acknowledged that the Board's recent introduction of the optional qualitative assessment has provided some cost reduction in testing goodwill for impairment, but many of those stakeholders stated that the level of cost reduction has not been significant.

The alternative gives private companies the option of straight-line amortization of goodwill over 10 years or less if the company demonstrates that another useful life is more appropriate. The company that elects the alternative must test for goodwill impairment only when a triggering event occurs that indicates that the fair value of an entity may be below its book value. FASB further simplified goodwill impairment testing for private companies that elect the alternative by eliminating Step 2 of the impairment test. The goodwill impairment is calculated as the excess of the entity's book value over its fair value.

New Guidance for Identifying Goodwill Impairment

In 2017, FASB issued ASU 2017-04 that simplifies goodwill impairment testing for public companies and for private companies that have not elected the private company alternative by eliminating the costly Step 2 from the goodwill impairment test (FASB, 2017). Companies will measure impairment losses as the excess of a company's book value over its fair value, removing the requirement of assigning a fair value to all of the individual assets, liabilities and unrecognized non-goodwill intangibles.

An entity still has the option to perform the qualitative assessment to determine if the quantitative impairment test (Step 1) is necessary. See Figure 2.

FIGURE 2: New Guidance for Identifying Goodwill Impairment

Step 1:

Fair value (FV) of reporting unit - Book value (BV) of reporting unit including goodwill (GW)

FV > BV of reporting unit	BV > FV of reporting unit
Goodwill is not impaired	Impairment = BV – FV of reporting unit

FASB Members' Concerns Regarding New Guidance

FASB acknowledges that the elimination of Step 2 in many cases could result in a less precise measurement of goodwill impairment, but point out that many users have indicated that the most useful information is in knowing whether an impairment has occurred rather than knowing the precise amount of the impairment. Three out of the seven

Under the new guidance, failing Step 1 will always result in a goodwill impairment.

FASB members dissented from the issuance of the update, because they believe that the one-step model could result in the misidentification of an impairment of goodwill.

The new guidance will simplify the impairment test, because it eliminates the need to determine the fair value of individual assets and liabilities. But measuring goodwill impairment based on the reporting unit as a whole rather than on the fair value of specific assets and liabilities could result in an entity recording more or less goodwill impairment than under existing GAAP. For example, the updated guidance could result in a goodwill impairment when in fact, the reason for the decrease in the fair value of the entity is a decline in the fair value of financial assets carried at amortized cost.

Under existing GAAP, it is possible for a reporting unit to fail Step 1, but for goodwill not to be impaired based on the impairment measurement in Step 2. Under the new guidance, failing Step 1 will always result in a goodwill impairment.

Other Considerations

Tax Deductible Goodwill

The update requires an entity to consider income tax effects from any tax deductible goodwill on the book value of the reporting unit when measuring the goodwill impairment loss. Goodwill amortization is deductible for some business combinations in certain jurisdictions, leading the acquiring company to record a deferred tax asset or deferred tax liability for the difference in the book basis and tax basis of the goodwill.

A subsequent decrease in the book basis of the reporting unit because of a goodwill impairment results in the related deferred tax asset increasing or the deferred tax liability decreasing. Either of these changes in deferred tax creates an increase in the book value of the net assets without a change in the fair value which could, in turn, trigger another impairment test.

To address the circular nature of the book value exceeding the fair value after the impairment charge, the update requires the acquiring company to apply a simultaneous equation[1] such that the preliminary goodwill impairment charge combined with the adjusted deferred tax effect will create a book value after impairment equal to the fair value of the reporting unit.

Reporting Units with Zero or Negative Book Values

Under existing GAAP, reporting units with a zero or negative book value are required to perform a qualitative assessment to determine whether it is more likely than not that goodwill is impaired. If goodwill impairment is indicated, the entity will perform Step 2 to determine the existence and amount of any impairment.

Under the new guidance, entities with these zero or negative book value

[1] Total goodwill impairment = preliminary impairment + [(tax rate/1 – tax rate) X preliminary impairment]

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The amendments in the update will be applied on a prospective basis and are effective for public companies that are SEC filers in fiscal years beginning after Dec. 15, 2019.

reporting units are not required to perform the qualitative assessment and Step 2 is eliminated. Because in Step 1 the fair value of the reporting unit is compared to the book value and because fair value is usually greater than zero, reporting units with zero or negative book values will generally be expected to pass the impairment test.

Effective Dates

The amendments in the update will be applied on a prospective basis and are effective for public companies that are SEC filers in fiscal years beginning after Dec. 15, 2019. Public companies that are not SEC filers should adopt the amendments in fiscal years beginning after Dec. 15, 2020, and all other entities that have not elected the private company goodwill alternative are required to adopt in fiscal years beginning after Dec. 15, 2021. Early adoption is permitted after Jan. 1, 2017.

Future Considerations

FASB separated the project on the subsequent measurement of goodwill into two phases. Phase 1 as discussed in this article resulted in ASU 2017-04. Phase 2 will consider permitting or requiring goodwill amortization and other changes for public companies and is postponed while FASB monitors the effectiveness of the current update.

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ABOUT THE AUTHOR

JANE N. BALDWIN, PH.D., CPA (inactive), is an accounting professor at Baylor University. She may be contacted at jane_baldwin@baylor.edu.

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CPE Article: FASB Simplifies the Test for Goodwill Impairment

By Jane N. Baldwin, Ph.D.

Today's CPA offers the self-study exam for readers to earn one hour of continuing professional education credit. The questions are based on technical information from the preceding article. If you score 70 or better, you will receive a certificate verifying you have earned one hour of CPE credit – granted as of the date the test arrived in the TSCPA office – in accordance with the rules of the Texas State Board of Public Accountancy (TSBPA). If you score below 70, you will receive a letter with your grade.

1. What was the motivation for FASB's revision of the goodwill impairment test?
- **A.** Congressional mandate
- **B.** FASB's simplification initiative
- **C.** Concern over the cost and complexity of the current standard
- **D.** Both B and C

2. Which of the following is false regarding the option to first assess qualitative factors related to goodwill impairment before assessing quantitative factors?
- **A.** The option is sometimes known as Step 0
- **B.** The option was available under the old standard, but not under the new standard
- **C.** If the company determines that it is more likely than not that the fair value of a reporting unit is less than its book value, then it will proceed with the quantitative test
- **D.** In practice, the majority of companies do not apply the option because of its cost and because of greater confidence in the quantitative test

3. What two things are compared in Step 1 of the goodwill impairment test?
- **A.** The fair value of the reporting unit to the book value of the reporting unit including goodwill
- **B.** The implied fair value of the goodwill to the book value of the goodwill
- **C.** The fair value of total intangible assets to the book value of total intangible assets
- **D.** The fair value of total assets to the fair value of total liabilities

4. In Step 1, goodwill is considered impaired if:
- **A.** The environment in which the company operates has become more competitive
- **B.** General economic conditions have deteriorated since the previous year
- **C.** The book value of the reporting unit including goodwill is greater than the fair value of the reporting unit
- **D.** None of the above

5. In its research regarding the treatment of goodwill impairment for private companies, FASB found that:
- **A.** The two-step impairment test provides limited decision-useful information
- **B.** Users of private company financial statements consider goodwill impairment losses extensively in their financial statement analysis
- **C.** The complexity in performing the goodwill impairment test is justified
- **D.** The benefits of the two-step impairment test exceed its cost

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6. The alternative treatment of goodwill gives private companies the option of straight-line amortization of goodwill over how many years?
- **A.** 8
- **B.** 10
- **C.** 15
- **D.** 40

7. Which of the following are important changes for public companies under the new goodwill impairment standard?
- **A.** Step 2 is eliminated
- **B.** Companies are no longer required to make a costly measurement of the fair value of individual assets and liabilities
- **C.** Impairment loss is calculated as the excess of a company's book value over its fair value
- **D.** All of the above

8. What is the primary concern of the three members of FASB who dissented from the issuance of the new standard?
- **A.** The updated standard will be more complicated
- **B.** The updated standard will be more costly to implement
- **C.** The one-step model could result in misidentification of an impairment of goodwill
- **D.** The calculation for goodwill impairment will always be smaller under the updated standard

9. Which of the following is true?
- **A.** A simultaneous equation is required to determine the tax effects from tax deductible goodwill impairments
- **B.** Under the updated standard, reporting units with zero or negative book values are not required to perform the qualitative assessment
- **C.** The update does not consider goodwill amortization for public companies, but FASB will address it in Phase 2
- **D.** All of the above are true

10. The update for the goodwill impairment test is effective for public companies that are SEC filers in fiscal years beginning after December 15, ____?
- **A.** 2019
- **B.** 2020
- **C.** 2021
- **D.** 2022

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