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The New Guidance for Goodwill Impairment



By Josef Rashty, CPA (<https://www.cpajournal.com/author/jrashty/>)

[September 2018 Issue](https://www.cpajournal.com/category/magazine/september-2018-issue/) (<https://www.cpajournal.com/category/magazine/september-2018-issue/>), [Feature Articles](https://www.cpajournal.com/category/feature-articles/) (<https://www.cpajournal.com/category/feature-articles/>) | © September 2018

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In January 2017, FASB issued Accounting Standards Update (ASU) 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, which eliminated the calculation of implied goodwill fair value. Instead, companies will record an impairment charge based on the excess of a reporting unit's carrying amount of goodwill over its fair value. This guidance simplifies the accounting as compared to prior GAAP. This article provides an overview of the goodwill impairment assessment under the new guidance and some specific income tax considerations regarding the financial implications of goodwill impairment.

Background

Accounting Standards Codification (ASC) Topic 350, *Intangibles—Goodwill and Other*, defines goodwill as “an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.” In other words, goodwill is the excess amount that an acquirer is willing to pay over the fair value of the acquired reporting unit (acquiree) from the perspective of an appropriate market participant—that is, the price that would be received if the reporting unit were sold in an orderly transaction between market participants. Subsequent to recording goodwill as part of a business combination, entities test goodwill, at least annually, at a reporting unit level for any impairment.

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Current Guidance

Under the current guidance, companies can first choose to assess any impairment based on qualitative factors (Step 0). This option allows entities to first assess these factors in order to determine whether a reporting unit's fair value is more likely Lived Intangibles," *The CPA Journal*, June 2014.) If a company fails this test or decides to bypass this step, it must proceed with the following two-step quantitative assessment of goodwill impairment.

First, the company compares the fair value of the reporting unit to its carrying amount (Step 1). If the fair value is lower, the company must then calculate any goodwill impairment charge by comparing the implied fair value of goodwill to its carrying amount (Step 2). Goodwill impairment may result if and only if the calculated implied fair value of goodwill is lower than its carrying amount. An impairment loss reduces the recorded goodwill and is irreversible.



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The current guidance requires companies to calculate the implied fair value of goodwill in Step 2 by calculating the fair value of all assets (including any unrecognized intangible assets) and liabilities of the reporting unit and subtracting it from the fair value of the reporting unit previously calculated in Step 1. This process makes any goodwill impairment analysis costly and complex. Private companies can, however, elect to amortize the goodwill that they have acquired in business combinations on a straight-line basis over 10 years, or less if the entity demonstrates that another useful life is more appropriate, and can elect to use a one-step goodwill impairment test (ASC 350-20-35-63). Thus, the new guidance may not be applicable to privately held companies. (For additional information, see Lange, Fornaro, and Buttermilch, "A New Era for Private Company Accounting Standards, Changes in Long-standing Practices for Goodwill", *The CPA Journal*, January 2015.)

New Guidance

FASB issued ASU 2017-04 in response to feedback it received from constituents in 2014, when it issued an accounting alternative that allowed private companies to amortize goodwill and use a simpler one-step impairment test (ASU 2014-02, *Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill*). ASU 2017-04 has tiered effective dates for its implementation:

- For public business entities that are SEC filers, fiscal years beginning after December 15, 2019
- For public business entities that are not SEC filers, fiscal years beginning after December 15, 2020
- For all other entities, including not-for-profits, fiscal years beginning after December 15, 2021.

Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. Many companies may well consider early adoption of the new guidance due to the complexity of the current guidance.

Impairment Assessment

Under ASU 2017-04, companies must record goodwill impairment charges if a reporting unit's carrying value exceeds its fair value. The impairment charge is based on that difference and is limited to the amount of goodwill allocated to that unit; thus, the new guidance eliminates Step 2 analysis of the current goodwill impairment testing. Companies continue to have the option of performing a qualitative assessment of goodwill impairment; however, if a company performs a qualitative assessment of its goodwill and fails, it must proceed with quantitative impairment testing (ASC 350-20-35-3A).

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Goodwill impairment charges under the new guidance may differ from the current guidance because the unit difference (carrying value of unit less fair value of unit) always overrides the goodwill difference (goodwill carrying value less goodwill fair value). Therefore, if the unit difference under the new guidance is higher or lower than the goodwill difference, it will replace the goodwill difference, which may create a higher or lower goodwill impairment charge. Furthermore, while some companies may not recognize any impairment under the current guidance when they fail Step 1, under the new guidance, if the carrying value of the reporting unit exceeds its fair value, there will always be some amount of goodwill impairment. **Exhibit 1** (<https://www.nysscpa.org/news/publications/the-cpa-journal/article-detail?ArticleID=12670#T1>) reflects goodwill impairment alternatives under different scenarios.

Exhibit 1

Sample Goodwill Impairment Scenarios

Exhibit 1 Sample Goodwill Impairment Scenarios					
Step 1		Step 2			
Carrying Value of Unit	Fair Value of Unit	Goodwill Carrying Value	Goodwill Fair Value	Impairment (New)	Impairment (Current)
\$105,000	\$100,000	\$12,000	\$10,000	\$5,000	\$2,000
\$105,000	\$100,000	\$12,000	\$7,000	\$5,000	\$5,000
\$105,000	\$90,000	\$12,000	\$14,000	\$12,000*	None
\$95,000	\$100,000	\$12,000	\$10,000	None	None
\$95,000	\$100,000	\$12,000	\$7,000	None	None
\$95,000	\$100,000	\$12,000	\$14,000	None	None

*Impairment charges (i.e., \$15,000) cannot exceed the carrying value of goodwill (i.e., \$12,000).

Order of Impairment Testing

If companies test goodwill and long-lived assets (held and used) at the same time because of a triggering event, they must follow a certain order in their impairment testing. Prior to testing goodwill for impairment, companies should first test other assets (e.g., accounts receivable, inventory) and indefinite-lived intangible assets, then long-lived assets (including definite-lived intangible assets), and finally, goodwill. They should record any impairment from each test before proceeding to the next test (ASC 350-20-35-31).

Exhibit 2

Straight Calculation of Goodwill Impairment and Deferred Tax Impact

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Exhibit 2
Straight Calculation of Goodwill Impairment and Deferred Tax Impact

	Carrying Value	Fair Value of Reporting Unit	Impairment Expense of Goodwill	Deferred Tax Adjustment	Carrying Value Amount after Adjustment
Goodwill	\$10,000		(\$1,000)		\$9,000
DTL	(\$2,000)			\$600	(\$1,400)
Other net assets	\$5,000				\$5,000
Total	\$13,000	\$12,000			\$12,600

DTL=deferred tax liability

The new guidance may result in goodwill impairment charges that would not have been recorded under prior GAAP. When companies recognize goodwill impairment charges, the circumstances may be such that they need to assess impairment for other assets subject to trigger-based events.

Dissent from Guidance

Several FASB board members dissented from the issuance of the new standard, arguing that it might result in an accounting outcome that does not reflect the relevant economic conditions and that there are instances that the one-step model may result in overstatement or understatement of goodwill impairment. For example, in a rising interest rate environment, there is a possibility that the fair value of reporting units with significant financial assets will fall below their book values. The new standard mandates the impairment of goodwill even in instances where the decrease in the reporting unit's fair value might have been caused by a reduction in the fair value of financial assets carried at amortized cost rather than a decline in the fair value of goodwill. To address the possible overstatement of goodwill impairment, the dissenting board members recommended that entities should have a choice of electing the two-step method.

The one-step method may also result in understatement of goodwill impairment if the fair value of liabilities is less than their carrying amounts, for example, due to deterioration of its creditworthiness. In this scenario, the entity may not be required to, and does not have any incentive to, record any impairment charges for its goodwill.

Finally, the new standard has incentivized companies with zero or negative carrying amounts of net assets to proceed immediately to Step 1 of goodwill impairment test to avoid reporting any goodwill impairment.

Tax Considerations at Acquisition

The income tax consequences of a business combination follow one of three patterns (see *Exhibit 3* (<https://www.nysscpa.org/news/publications/the-cpa-journal/article-detail?ArticleID=12670#T3>)). In a taxable transaction, the acquirer takes a fair value tax basis in the net assets acquired; in a nontaxable transaction, the acquirer takes a carryover basis in the net assets but a fair value basis in any acquired stock; in a nontaxable exchange, the acquirer takes a carryover basis in both the net assets and any acquired stock. The tax treatment of an acquisition may directly or indirectly affect the price of the transaction and the amount of goodwill and its future possible impairment, since an acquirer might be willing to pay more for an acquisition in a taxable transaction if such transaction can provide a step-up in the tax basis of the acquired net assets. Furthermore, the structure of an acquisition can also dictate whether an acquirer can benefit from the existing tax attributes (e.g., tax credit carryforwards and net operating loss) of an acquiree.

Exhibit 3

Tax Treatment of Business Combinations

Exhibit 3
Tax Treatment of Business Combinations

Type of Transaction	Tax Treatment
Taxable transaction (sale of net assets)	Taxable to the acquiree Acquirer takes a fair value tax basis in net assets
Nontaxable transaction (sale of stock)	Taxable to the acquiree Acquirer takes a fair value tax basis in the acquired stock but carry-over tax basis in the net assets
Nontaxable exchange	Nontaxable to the acquiree (i.e., acquiree does not recognize taxable gain or loss) Acquirer takes a carryover basis in both the acquired stock and net assets

Under the current guidance, Step 2 is generally comparable whether the transaction is taxable or nontaxable because, by definition, the amount of goodwill should remain the same whether the transaction is taxable or nontaxable. Under the new guidance, however, goodwill impairment in Step 1 is generally lower when the acquisition is a taxable transaction because the new guidance determines the impairment by comparing the total carrying value of the unit to its total fair value. Because an acquirer is usually willing to pay a higher sale price for a taxable transaction as opposed to a nontaxable transaction, the total fair value is usually higher in a taxable transaction, resulting in a lower impairment charge. Furthermore, companies may need to include deferred tax balances related to assets (in this case goodwill) and liabilities in determining the reporting unit's carrying value.

Tax Implications of Goodwill Impairment

Under ASU 2017-04, companies recognize an impairment charge to the extent that the carrying value of a reporting unit exceeds its fair value (not to exceed the carrying value of goodwill). To determine the fair value of the unit, companies determine whether the hypothetical sale has occurred in a taxable or nontaxable transaction, as discussed above. This determination could affect the fair value of the unit and thus any goodwill impairment charges.

In certain jurisdictions, goodwill amortization is tax deductible. If a company or reporting unit operates in these jurisdictions, goodwill impairment charges may decrease its deferred tax liability (DTL) or increase its deferred tax asset (DTA). A decrease in DTL or an increase in DTA causes an immediate increase in the carrying value of the reporting unit, which would require additional impairment charges (ASC 350-20-35-20 & 21 and ASC 850-740-25).

ASU 2017-04 has addressed this issue and requires an entity to calculate the impairment charge and the deferred tax effect simultaneously (similar to how an entity calculates goodwill and the related DTAs in a business combination). For example, if Entity A has goodwill impairment charges of \$1,000 (the excess of the carrying amount of reporting unit over its fair value) and its effective tax rate is 40%, the impact of impairment on the carrying value of goodwill is \$600 [$\$1,000 - (\$1,000 \times 40\%)$]. If Entity A uses simultaneous equations (based on the new guidance), however, the goodwill impairment charge is \$666 [40% divided by $(1 - 40\%) \times \$1,000$, ASC 350-20-55-23C & D].

Exhibit 2 (<https://www.nysscpa.org/news/publications/the-cpa-journal/article-detail?ArticleID=12670#T2>)

reflects that straight application of a \$1,000 goodwill impairment loss results in a carrying value amount of \$12,600, which would still exceed the fair value of \$12,000. **Exhibit 4** (<https://www.nysscpa.org/news/publications/the-cpa-journal/article-detail?ArticleID=12670#T4>) reflects what happens when Entity A calculates its goodwill impairment charge and deferred tax impact simultaneously. In this scenario, the carrying amount of \$12,000 equals the fair value of the unit for \$12,000. The journal entry for goodwill impairment is as follows:

Goodwill impairment	\$1,000
DTL	\$666
Goodwill	\$1,666

Exhibit 4

Simultaneous Calculation of Goodwill Impairment and Deferred Tax Impact

Exhibit 4 Simultaneous Calculation of Goodwill Impairment and Deferred Tax Impact					
	Carrying Value	Fair Value of Reporting Unit	Impairment Expense of Goodwill	Deferred Tax Adjustment	Carrying Amount after Adjustment
Goodwill	\$10,000		(\$1,000)	(\$666)	\$8,334
DTL	(\$2,000)			\$666	(\$1,334)
Other net assets	\$5,000				\$5,000
Total	\$13,000	\$12,000			\$12,000

Entities 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. *Exhibit 5*

(<https://www.nysscpa.org/news/publications/the-cpa-journal/article-detail?ArticleID=12670#T5>) reflects the impairment of goodwill when goodwill assigned to the reporting unit is not taxable. The journal entry for goodwill impairment is as follows:

Goodwill impairment	\$1,000
Goodwill	\$1,000

Exhibit 5

Impairment of Goodwill When Goodwill Assigned to Reporting Unit Is Not Taxable

Exhibit 5
Impairment of Goodwill When Goodwill Assigned to Reporting Unit Is Not Taxable

	Carrying Value	Fair Value of Reporting Unit	Impairment Expense of Goodwill	Deferred Tax Adjustment	Carrying Amount after Adjustment
Goodwill	\$10,000		(1,000)		\$9,000
DTL	\$0				\$0
Other net assets	\$5,000				\$5,000
Total	\$15,000	\$14,000			\$14,000

Going Forward

Many companies may decide to adopt the new goodwill impairment guidance in ASU 2017-04 prior to its effective date because it simplifies the goodwill impairment testing process. But it is worth noting that the guidance complicates the tax implications of goodwill accounting in certain jurisdictions where goodwill amortization is deductible for tax purposes. Companies should examine the specific details of their goodwill structure to determine the impact of the new guidance for financial reporting purposes.

Josef Rashty, CPA is an adjunct professor of accounting at Golden Gate University in San Francisco, Calif. He can be reached at j_rashty@yahoo.com (mailto:j_rashty@yahoo.com).

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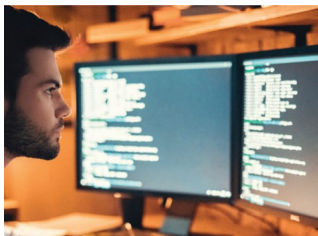
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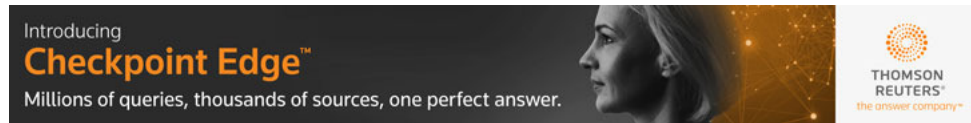


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