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FASB Simplifies Goodwill Impairment Testing . . . Again

In January 2017, the Financial Accounting Standards Board (FASB) issued additional revised guidance for goodwill impairment testing that's intended to make the process easier and less costly. The latest amendments, found in Accounting Standards Update (ASU) No. 2017-04, Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment, establish a one-step process for testing goodwill for a decrease in value.

Testing Goodwill for Impairment

The term "goodwill" refers to the residual asset recognized in a business combination, such as a merger, after recognizing all other identifiable assets acquired and liabilities assumed. This premium is considered an intangible asset that generally includes the reputation of the purchased business and its competitive advantage in the market. Under U.S. Generally Accepted Accounting Principles (GAAP), goodwill is carried on the books at its initial value less any impairment.

The existing rules consider goodwill to be impaired when the implied fair value of goodwill in a "reporting unit" of a company is less than its carrying amount, or book value, including any deferred income taxes. (A reporting unit is an operating unit that has its own discrete financial information, separate from the overall company.)

Under existing GAAP, unless management adopts one of the simplified alternatives (described below), a company must test goodwill for impairment annually — and between annual tests in certain circumstances — using a two-step process:

1. The company calculates the fair value of the reporting unit and compares that amount with the carrying amount of the reporting unit, including goodwill. If the carrying amount exceeds the fair value, the company must perform the second step. If not, testing stops.

2. The company measures the amount of goodwill impairment, if any, by comparing the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. Measuring the implied fair value of goodwill requires a process similar to a purchase price allocation that's done when goodwill is initially acquired.

The company must then recognize any impairment as a loss on its income statement. The carrying amount of goodwill is also reduced to its implied fair value.

Simplification Efforts

For years, companies have complained that the benefits of impairment testing didn't justify the costs, including the fees paid to outside business valuation experts to estimate fair value. They told the FASB that the test was too complicated and asked for simplified guidance.

In 2011, the FASB responded by issuing a standard that gives companies the option of making a qualitative evaluation to determine whether they must test for goodwill impairment. If a company chooses this option, it assesses whether relevant events and circumstances — such as general economic conditions, regulatory changes and the company's financial performance — make it "more likely than not" that the fair value of the reporting unit's goodwill is less than its carrying amount. If the company determines there's at least a 50% chance that the fair value of goodwill exceeds its carrying value, impairment testing isn't required.

In 2014, the FASB decided to give private companies the option of amortizing goodwill straight-line over a period of 10 years (or less if the company demonstrates that another useful life is more appropriate). A private company that elects this alternative must test for goodwill impairment only when a triggering event — such as a significant adverse change in business climate, legal issues or loss of key personnel — occurs that indicates the fair value of the company or a reporting unit may be below its carrying amount.

The private company alternative also drops the second step of the existing impairment test. Instead, an impairment equals the amount by which the carrying amount of the entire company or reporting unit exceeds its fair value. The goodwill impairment loss can't, however, exceed the carrying amount of the company's or reporting unit's goodwill.

Elimination of Second Step

Now, the FASB has decided to simplify goodwill impairment testing again, this time for public companies as well as for private companies that haven't elected to amortize goodwill. ASU 2017-04 calls for a goodwill impairment loss to be measured as the excess of the carrying amount of a reporting unit (that includes goodwill) over its fair value. Impairment losses are limited to the carrying amount of goodwill allocated to the reporting unit.

Put simply, the update eliminates the second step of the goodwill impairment test. Under the updated guidance, companies will no longer determine goodwill impairment by calculating the implied fair value of goodwill. The word "implied" has been dropped from the FASB's definition of goodwill impairment.

Unlike the private company reporting alternative, the latest update doesn't give public companies the option to amortize goodwill. That part of the FASB's goodwill reporting project has been moved to the board's research agenda. In the meantime, the FASB will monitor the effectiveness of the latest update before proposing any additional changes to the goodwill reporting model.

Dissenting Views

The FASB acknowledges that calculating goodwill impairment at the reporting unit level could result in a less precise measurement of goodwill impairment than under the existing two-step process. But many financial statement users have told the FASB that the most useful information is identifying impairment, not measuring the precise amount of that impairment.

Three FASB members dissented from the issuance of the updated standard. They contend that there are situations in which applying a one-step test could result in the misidentification of a goodwill impairment.

In some cases, it could cause impairment to be identified when it doesn't actually exist. For example, in a rising interest rate environment, the fair value of reporting units of financial institutions and other entities with significant financial assets (such as insurance companies) could possibly fall below their carrying amounts. Applying the updated guidance could result in a goodwill impairment even though the decrease in the fair value of the reporting unit may actually be caused by a reduction in the fair value of financial assets carried at amortized cost.

In other cases, it could result in underidentification of impairment. This could occur if the fair value of liabilities is less than the carrying amount, which might allow a company to avoid reporting an impairment charge when it would have been warranted had the two-step test been applied.

In light of these scenarios, the dissenting members would have preferred for companies to be given the option to continue applying the existing two-step impairment test to acquired goodwill.

Implementation Schedule

Public companies that file reports with the Securities and Exchange Commission (SEC) must adopt the updated standard for annual or interim periods in fiscal years beginning after December 15, 2019. Public companies that aren't SEC filers must adopt the standard for annual or interim periods in fiscal years beginning after December 15, 2020. All other organizations, including not-for-profit groups, must adopt it for the annual or interim periods in fiscal years beginning after December 15, 2021.

Early adoption of the updated standard is permitted for interim or annual periods after January 1, 2017. Because this standard is expected to be simpler and less costly than the existing guidance, it will likely be adopted early by many companies that report goodwill and are required to test it for impairment under GAAP.

Please contact us if you have questions regarding impairment testing requirements or would like to know if early adoption of the updated standard makes sense for your company. We are happy to discuss this with you and help you to better achieve your financial objectives. Feel free to reach out to your personal advisor or contact us at: cpas@dzhphillips.com or call (415) 781-2500.