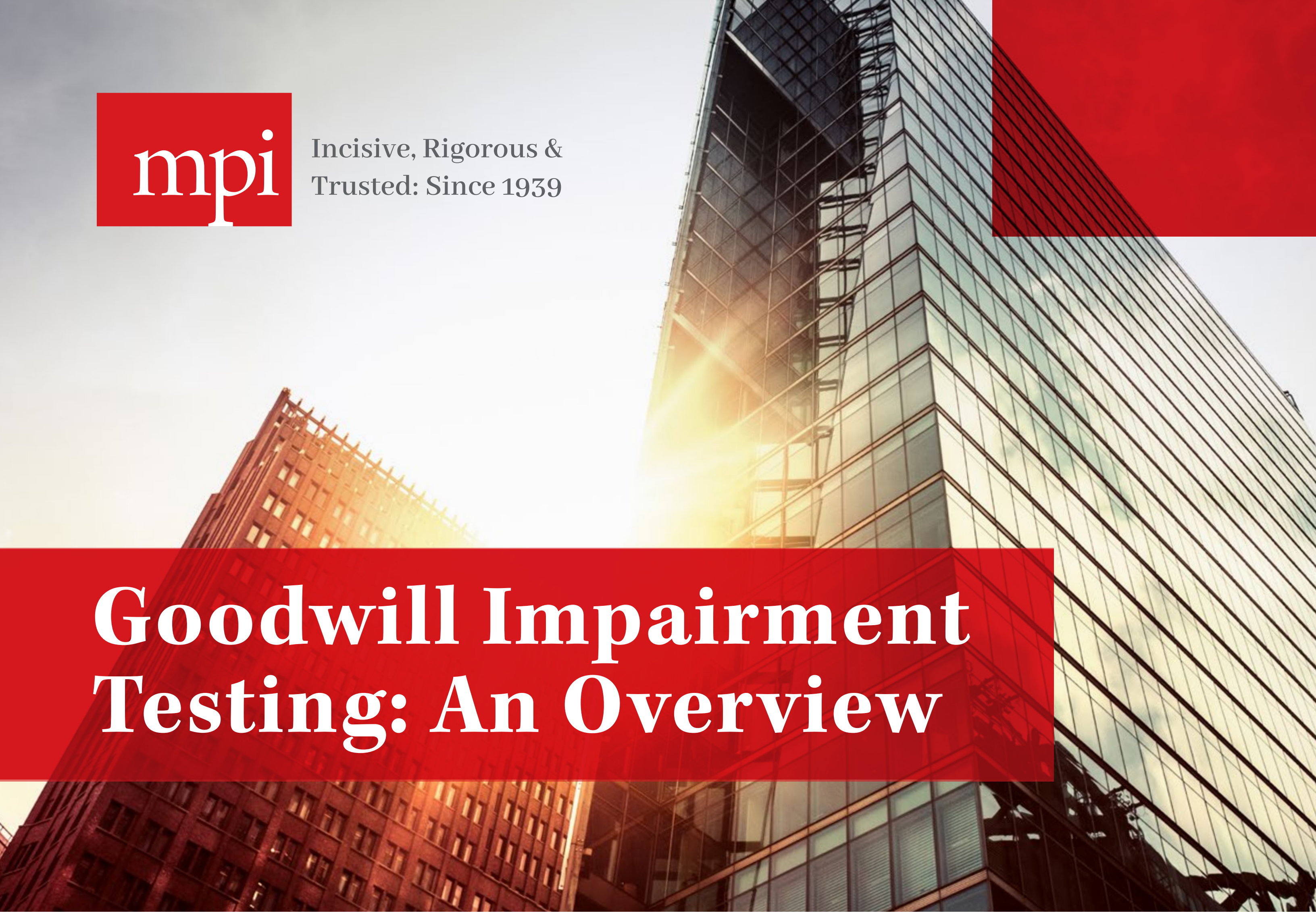

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Goodwill Impairment Testing: An Overview

Introduction

By way of background, the accounting rules pertaining to goodwill impairment under U.S. GAAP are outlined in Accounting Standards Codification Topic 350 Intangibles—Goodwill and Other ("ASC 350"). In general, goodwill shall not be amortized but rather shall be tested at least annually for impairment at the reporting unit level. Historically, under ASC 350, the impairment of goodwill was defined as "the condition that exists when the carrying amount of goodwill exceeds its implied fair value."

In January 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update 2017-04 ("ASU 2017-04" or the "Update"), which was intended to simplify the accounting for goodwill impairments by eliminating Step 2 (discussed below) from the goodwill impairment test. Therefore, the impairment test has been modified from a concept of impairment from the condition that exists when the carrying amount of goodwill exceeds its implied fair value, to the condition that exists when the carrying amount of a reporting unit exceeds its fair value.

The remainder of this memo outlines the goodwill impairment test, and provides background on changes integrated by the FASB in recent years including the recent Update.

Goodwill Impairment Testing

Prior to the Update, the goodwill impairment test could involve up to three steps. Companies first have an option to assess qualitative factors to determine whether the existence of events or circumstances lead to a conclusion that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. In practice, this qualitative test is often referred to as "Step Zero". Step Zero is an optional test and, if performed, ASC 350 provides examples of events and circumstances that should be considered in performing the qualitative test.

If it is determined that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing a quantitative "Step 1" analysis (discussed below) is unnecessary. If, however, it is determined that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then Step 1 must be prepared.

Historically, Step 1 was undertaken to identify potential impairment. Under Step 1, the fair value of the reporting unit is determined and compared with its carrying amount, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, then goodwill is considered not impaired and no further analytics are required. On the other hand, if the carrying amount of a reporting unit exceeds its fair value, "Step 2" of the goodwill impairment test is necessary in order to determine the amount of the impairment loss, if any.

Under Step 2, the implied fair value of goodwill (for a reporting unit) was compared to the carrying amount of goodwill. To the extent that the carrying amount of goodwill exceeded the fair value of goodwill, an impairment charge was recognized in an amount equal to the differential. With regard to the implied fair value of goodwill, such was determined in the same manner as the amount of goodwill recognized in a business combination. To this end, the entity would assign the fair value of a reporting unit to all of the assets and liabilities of that unit as if the reporting unit had been acquired. The excess of the fair value of the reporting unit over the amounts assigned to its net assets was an indication of the implied fair value of goodwill.

As outlined above, the impairment test for many entities had previously comprised three steps. However, in January 2014, the FASB issued ASU 2014-02 which introduced an accounting alternative for private companies.

ASU 2014-02, now subsumed into ASC 350, allows private companies to amortize goodwill over a period not to exceed 10 years instead of not amortizing it.

It also allows private companies to perform a simplified impairment test, specifically eliminating Step 2. Therefore, for private companies that elect the accounting alternative, the goodwill impairment test was reduced to two steps.

It should be noted that the accounting alternative for private companies was generated as a response to concerns regarding the cost and complexity of the goodwill impairment test, as expressed by private companies and their stakeholders. The FASB received feedback that many public business entities had similar concerns about the cost and complexity of the annual goodwill impairment test; therefore, the FASB added a research project to its agenda relative to the simplification of goodwill. More specifically, the FASB added to its agenda a two-phase goodwill simplification project. ASU 2017-04 was issued in conjunction with Phase 1 of the project.

[1] The accounting rules allow private companies to amortize goodwill. Goodwill amortization for private companies is discussed subsequently herein.
[2] FASB Accounting Standards Update No. 2017-04, Simplifying the Test for Goodwill Impairment.
[3] ASC 350-20-35-3
[4] ASC 350-20-35-3C
[5] Formerly ASC 350-20-35-4

ASU 2017-04

ASU 2017-04 eliminates Step 2 from the goodwill impairment test, an adjustment which is applicable to public companies and other entities that have goodwill and have not elected the private company alternative. Companies may still elect to prepare the qualitative test. Next, the Step 1 quantitative test is prepared, if necessary, and an entity will compare the fair value of a reporting unit with its carrying amount. An impairment charge will be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value.

Although the qualitative test has not been removed, ASU 2017-04 eliminates the requirement for reporting units with a zero or negative carrying amount to perform a qualitative assessment and, if necessary, to perform Step 2 of the goodwill impairment test. Instead, all reporting units, even those with a zero or negative carrying amount will apply the same impairment test. Therefore, the goodwill of a reporting unit with zero or negative carrying value will not be impaired, even when conditions underlying the reporting unit indicate that goodwill is impaired. Entities will, however, be required to disclose any reporting units with zero or negative carrying amounts and the respective amounts of goodwill allocated to those reporting units.

For public business entities that are SEC filers, ASU 2017-04 is effective for annual and any interim impairment tests for periods beginning after December 15, 2019. Public business entities that are not SEC filers should apply the new guidance to annual and any interim impairment tests for periods beginning after December 15, 2020. For all other entities, the ASU is effective for annual and any interim impairment tests for periods beginning after December 15, 2021. Early adoption is allowed for all entities as of January 1, 2017, for annual and any interim impairment tests occurring after January 1, 2017.

For private companies, the ASU also notes an election to switch from the accounting alternative should occur prospectively on or before the above referenced effective date. Private companies that switch from the accounting alternative on or before the effective date would not need to justify preferability for the accounting change.

[6] The charge could not exceed the carrying amount of goodwill.
[7] Formerly ASC 350-20-35-9:11
[8] In late 2016, the FASB decided to suspend deliberations on Phase 2 which remains on its research agenda. Before evaluating whether to make any additional changes to the model for the subsequent accounting for goodwill, the FASB will evaluate the effectiveness of ASU 2017-04.

Summary

As outlined above, ASC 2017-04 should reduce the time and costs associated with the goodwill impairment test by reducing the number of required steps. The impairment test has been modified from a concept of impairment from the condition that exists when the carrying amount of goodwill exceeds its implied fair value, to the condition that exists when the carrying amount of a reporting unit exceeds its fair value. The implication here is that an entity could record a goodwill impairment that is attributable to a decline in the fair value of non-goodwill assets.

While the change appears sensible, there will be circumstances where additional disclosures are required, most notably in cases where entities that have one or more reporting units with zero of negative carrying amounts. Lastly, we note that removing Step 2 from the goodwill impairment test more closely aligns U.S. GAAP with IFRS, as there is only one step in the goodwill impairment test under IFRS. Under IFRS, the impairment of goodwill and intangible assets is addressed in *International Accounting Standard 36 – Impairment of Assets*.

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