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ASU 2017-04: Goodwill Simplifications
Implementation Considerations for 2017 Year Ends and Beyond

On January 26, 2017, the FASB issued Accounting Standards Update (ASU) 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, which eliminates Step 2 from the goodwill impairment test currently prescribed in U.S. generally accepted accounting principles (U.S. GAAP) (paragraphs 9-11 of FASB *Accounting Standards Codification* (FASB ASC) 350-20-35). ASU 2017-04 is the result of a FASB project to consider whether simplifications to accounting for goodwill such as the accounting alternative available to private companies related to the subsequent measurement of goodwill (see ASU 2014-02, *Accounting for Goodwill*, and the related CPEA report) also should be made available for public business entities (PBEs) and not-for profits (NFPs) as well as other entities that do not elect the private company alternative. ASU 2017-04 also has significant nuances addressing goodwill impairment with zero or negative carrying value, deferred taxes, and interaction with the new current expected credit losses (CECL) model for financial assets that should not be overlooked.

CPEA Observation: Based on polling done by CPEA and other organizations, the private company accounting alternative in ASU 2014-02 is popular, however, some private companies did not adopt the private company alternative. ASU 2017-04 will apply to those entities and those entities may wish to early adopt ASU 2017-04 when permitted (see below).

As a reminder, ASU 2014-02 provides a simplified alternative for private companies that can be used in accounting for post-acquisition goodwill. The alternative consists of several changes to the subsequent measurement of goodwill for an entity that elects it, including amortization of goodwill over a 10-year period and a one-step impairment test performed only upon a triggering event. Further, as we previously noted, ASU 2016-03,

Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance (A Consensus of the Private Company Council) allows entities a one-time, anytime option to elect ASU 2014-02 without needing to establish preferability under FASB ASC 250.

Current U.S.GAAP (for those entities that don't or are not permitted to apply the private company alternative) includes a two-step goodwill impairment test for entities that have not adopted the private company alternative for goodwill. Step 1 of that test requires an entity to compare the fair value of a reporting unit with its carrying amount, including goodwill, to determine if an impairment exists. If the carrying amount exceeds the fair value of the reporting unit, an entity performs Step 2 of the goodwill impairment test. Step 2 includes determining the implied fair value of reporting unit goodwill and comparing it with its carrying amount.

CPEA Observation. The calculation required by Step 2 essentially involves assumption of a hypothetical business combination so that the acquisition method in FASB ASC 805, *Business Combinations*, has to be used to determine the implied fair value of goodwill after measuring identifiable assets and liabilities of the reporting unit. Stakeholders have long criticized Step 2 as burdensome and complicated.

When the amendments in ASU 2017-04 are adopted, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Accordingly, goodwill impairment testing becomes a one-step, rather than a two-step procedure.

CPEA Observation: The FASB acknowledges that calculating impairment by comparing the carrying amount of a reporting unit with its fair value in many cases could result in a less precise amount of goodwill impairment and that this concern may be greater for companies in certain industries. However, many financial statement users have indicated that the most useful information is knowing whether an impairment charge is warranted, not the precise amount of that impairment. The amendments in ASU 2017-04 may result in more impairment loss in some cases and less loss in other cases, depending on the specific circumstances. We also note that the costly two-step model, while possibly more precise, was not perfect. For example, the computation of the implied fair value of the reporting unit goodwill was not able to discern between goodwill at the acquisition date and goodwill self-developed after the acquisition date. Thus, the two-step model was therefore inherently bias toward acquisitive entities in the

recognition of goodwill. The FASB concluded that any increased precision with the two-step test was not worth the cost.

Computation of the Carrying Value

The first step of the goodwill impairment test compares the fair value of a reporting unit with its carrying amount, including goodwill. The manner in which the carrying value is determined is not prescribed by the FASB ASC or ASU 2017-04. Therefore, in practice, this comparison may be conducted at the level of total assets less operating liabilities (also referred to as an enterprise premise of value) or "net assets" (also referred to as an entity or equity premise of value). U.S. GAAP, however, does require "that the elements of a reporting unit be the same for determining both its carrying amount and its fair value and that the methodology be consistently applied." An example of the differences in computation of carrying value follows below:

	Carrying Value	
Using:	Enterprise Value	Entity/Equity Value
Accounts Receivable	$100	$100
Net Fixed Assets	200	200
Accounts Payable	(50)	(50)
Shareholder Loan		(100)
Carrying Value	$250	$150

Using the enterprise value, the carrying value is higher, 250, as the financing related shareholder loan is excluded from the computation of carrying value. The underlying premise behind the enterprise value is that financing liabilities are not operating in nature and would be replaced by a likely buyer with its own liabilities or equity. To put it another way, a buyer can choose its own manner of financing operating net assets and that should not impact value. In accordance with the U.S. GAAP requirement "that the elements of a reporting unit be the same for determining both its carrying amount and its fair value and that the methodology be consistently applied," you would generally exclude interest on the shareholder loan above in the discounted cash flows to determine the fair value using the enterprise value. This would typically result in a higher fair value as compared to the entity value, since interest on the shareholder loan would not be excluded from the discounted cash flows to determine the fair value using the entity/equity method.

Practice Note: Two of the FASB members dissented from the issuance of ASU 2017-04, in part, due to concerns about the computation of carrying value. They noted that "an entity experiencing an increase in the fair value of liabilities will lean toward choosing an enterprise premise of value [which *excludes* financing liabilities from fair value and carrying value computations] to limit the overstatement of the existence and amount of

impairment. In contrast, an entity experiencing a decrease in the fair value of liabilities will lean toward choosing an entity [equity] premise of value to understate the existence and amount of impairment [which *includes* financing liabilities from the fair value and carrying value computations]."

Reporting Unit with Zero or Negative Carrying Amounts

The amendments in ASU 2017-04 also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment, and if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. As a result, goodwill impairments for reporting units with zero or negative carrying amounts, while theoretically possible, are likely to be rare. In ASU 2010-28, (a previous effort to address reporting units with zero or negative carrying amounts) the FASB noted in BC 2 that, "some entities concluded that Step 1 of the test is passed because the fair value of their reporting unit will generally be greater than zero." Accordingly, since the fair value of a reporting unit with zero or negative carrying amount will generally be greater than zero, the FASB requires additional disclosures for reporting units with goodwill that have zero or negative carrying amounts.

Practice Note: The goodwill accounting alternative made available to private companies through the issuance of ASU 2014-02 allows a policy election for an entity to perform the impairment test at the entity level or the reporting unit level. In contrast, ASU 2017-04 requires the impairment test to be performed at the reporting unit level.

The FASB recognized that entities may desire to structure computations of carrying amounts such that they become zero or negative (and, as noted above, are, therefore, generally exempt from recognition of a potential goodwill impairment). The Basis for Conclusions (BC) notes that determining the carrying value "allows for significant judgment" but that "it requires that the elements of a reporting unit be the same for determining both its carrying amount and its fair value and that the methodology be consistently applied." Given this, BC 50-51 further indicates that:

> The Board notes that the amendments in this Update should not necessarily trigger changes to the composition of a reporting unit and that preparers, auditors, and regulators should pay close attention to any change to a reporting unit that results in a zero or negative carrying amount, including changes made leading up to the adoption of the new guidance given the length of time until the effective dates.
>
> The Board emphasizes that the allocation of assets and liabilities to reporting units should not be viewed as an opportunity to avoid impairment charges and

> should only be changed if there is a change in facts and circumstances for a reporting unit.

However, in BC 52, the FASB did allow that:

> [T]he Board notes that the issuance of this guidance could be considered a change in facts and circumstances in some cases and it might be appropriate to change valuation methods in certain circumstances. For example, if a reporting unit with a negative carrying amount is reevaluated and the entity determines that a more representative impairment evaluation could be performed under the one-step test using an enterprise premise of fair value, it would be reasonable for it to exclude previously included financing liabilities from the carrying amount of the reporting unit. However, the Board reiterates that the allocation of assets and liabilities to reporting units should not be viewed as an opportunity to achieve a desired impairment result and that a change in valuation method must be supportable.

Practice Note: While many private companies may not now appreciate the nuances involved in determining the carrying value, we think over time the ability to greatly reduce goodwill impairment analysis via a reporting unit with zero or negative carrying value may cause broader awareness amongst private companies. Practitioners will need to consider aforementioned portions of the BC in evaluations of changes made to impairment analysis.

CPEA Observation: The FASB observed in the BC that the population of reporting units with zero or negative carrying amounts is small. Presumably, this conclusion was based on publicly available financial statements. Whether or not this conclusion also applies to financial statements that are not publicly available is uncertain. However, given the private company accounting alternative already available for private companies is partially based on the lesser relevance of goodwill to users of private company financial statements, the focus on publicly available financial statements appears appropriate.

Foreign Currency Translation

ASU 2017-04 also clarifies that foreign currency translation adjustments should not be allocated to a reporting unit from an entity's accumulated other comprehensive income. The reporting unit's carrying amount should include only the currently translated balances of the assets and liabilities assigned to the reporting unit.

Practice Note*:* On the issue noted above, prior to the issuance of ASU 2017-04, some entities and practitioners were analogizing to FASB ASC 830, *Foreign Currency Matters,* related to cumulative translation adjustments whereby an entity should include some or

all of the cumulative translation adjustment as part of the carrying amount of an investment in a foreign entity when testing that investment for impairment if the entity has committed to a plan to dispose of that investment. As noted in BC 56, the FASB concluded that the testing of an investment (even if it is a consolidated investment that includes goodwill) for impairment is different from testing goodwill for impairment. Additionally, the FASB notes that the cumulative translation adjustment generally would not meet the criteria for inclusion in a reporting unit in accordance with FASB ASC 350-20-35-39.

Interaction with Deferred Tax Balances

Most private companies are pass-through entities and, therefore, deferred tax balances are not relevant in the impairment test for goodwill. However, for those private entities which are taxable (such as C-corporations) and have tax deductible goodwill, ASU 2017-04 addressed a circularity issue that the new one step model creates. Specifically, when goodwill of a reporting unit is tax deductible, the impairment of goodwill creates a cycle of impairment because the decrease in the book value of goodwill increases the deferred tax asset (or decreases the deferred tax liability) such that the carrying amount of the reporting unit increases. However, there is no corresponding increase in the fair value of the reporting unit and this could trigger another impairment test.

FASB ASC 350-20-55-23B illustrates the use of a simultaneous equation when tax deductible goodwill is present to account for the increase in the carrying amount from the deferred tax benefit.

> Beta Entity has goodwill from an acquisition in Reporting Unit X. All of the goodwill allocated to Reporting Unit X is tax deductible. On October 1, 20X6 (the date of the annual impairment test for the reporting unit), Reporting Unit X had a book value of goodwill of $400, which is all tax deductible, deferred tax assets of $200 relating to the tax-deductible goodwill, and book value of other net assets of $400. Reporting Unit X is subject to a 40 percent income tax rate. Beta Entity estimated the fair value of Reporting Unit X at $900.

	Carrying Amount	Fair Value	Preliminary Impairment	Preliminary Deferred Tax Adjustment	Carry Amount After Preliminary Impairment
Goodwill	$ 400	$ ---	$ (100)	$ ---	$ 300
Deferred Taxes	200	---	---	40	240
Other Net Assets	400	---	---	---	400
Total	$1,000	$ 900	$ (100)	$ 40	$ 900

In the Example above, the carrying amount of Reporting Unit X immediately after the impairment charge exceeds its fair value by the amount of the increase in the deferred tax asset calculated as 40 percent of the impairment charge. To address the circular nature of the carrying amount exceeding the fair value, instead of continuing to calculate impairment on the excess of carrying amount over fair value until those amounts are equal, Beta Entity would apply the simultaneous equation demonstrated in paragraphs 805-740-55-9 through 55-13 to Reporting Unit X, as follows.

Simultaneous equation: [tax rate/(1 – tax rate)] × (preliminary temporary difference) = deferred tax asset

Equation for this example: 40%/(1 – 40%) × 100 = 67

	Carrying Amount	Fair Value	Preliminary Impairment	Adjustment for Equation	Carrying Amount After Impairment
Goodwill	$ 400	$ ---	$ (100)	$ (67)	$ 233
Deferred Taxes	200	---	---	67	267
Other Net Assets	400	---	---	--	400
Total	$1,000	$ 900	$ (100)	$ 0	$ 900

The company would report a $167 goodwill impairment charge partially offset by a $67 deferred tax benefit recognized in the income tax line. If the impairment charge calculated using the equation exceeds the total goodwill allocated to a reporting unit, the total impairment charge would be limited to the goodwill amount.

Effective Dates, Transition, Applicability

A public business entity (PBE) that is a U.S. Securities and Exchange Commission (SEC) filer should adopt the amendments in ASU 2017-04 for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. A PBE that is not a SEC filer should adopt the amendments in ASU 2017-04 for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020. All other entities, including not-for-profit entities (NFPs), adopting the amendments in ASU 2017-04, should do so for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021. Early adoption is permitted for interim or annual goodwill impairment tests performed with a measurement date after January 1, 2017.

Practice Note: The relatively long implementation period for ASU 2017-04 is intended to reduce the potential for double counting of losses due to the future implementation of the current expected credit loss (CECL) model for financial assets. In BC 60-61, the FASB notes an entity that experiences a decline in the fair value of its loan portfolio after adopting ASU 2017-04 and before adopting the CECL model could record a goodwill impairment charge if the decrease in loan value results in the carrying amount of the reporting unit exceeding its fair value. Subsequently, the entity could record another charge for loan impairment when it adopts the CECL model and records the expected credit losses associated with those loans. As a result, entities in the financial institutions industry should carefully weigh early adoption as well as other entities that will have significant impairment losses upon the adoption of CECL. We have previously noted that CECL could significantly impact non-financial institutions. Aligning the effective dates of the guidance in this ASU with the CECL guidance allows 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, eliminating the potential double counting of losses associated with the loans.

CPEA Observation: The CPEA believes that many entities (other than those significantly impacted by CECL), unable to adopt the goodwill accounting alternative offered in ASU 2014-02 (NFPs, PBEs, and employee benefit plans), will choose to early implement the amendments in ASU 2017-04. In fact, the FASB envisions that most entities will adopt the amendments before the effective date. However, since early adoption is permitted for interim or annual goodwill impairment tests performed with a measurement date after January 1, 2017, calendar year 2016 engagements would not be able to apply ASU 2017-04. Further, practitioners will need to be proactive on implementation since ASU 2017-04 is not a “must do” until 2022 for calendar year non-PBEs.

An entity should apply the amendments in ASU 2017-04 on a prospective basis. An entity is required to disclose the nature of, and reason for, the change in accounting principle upon transition. That disclosure should be provided in the first annual period and in the interim period within the first annual period when the entity initially adopts the amendments in ASU 2017-04.

The amendments in ASU 2017-04 are required for PBEs and other entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill.

Private companies that have adopted the private company alternative for goodwill but not the private company alternative to subsume certain intangible assets into goodwill (see ASU 2014-18, *Accounting for Identifiable Intangible Assets in a Business*

Combination, and the related CPEA report) are permitted, but not required, to adopt the amendments in ASU 2017-04 without having to justify preferability of the accounting change if it is adopted on or before the effective date.

Private companies that have adopted the private company alternative to subsume certain intangible assets into goodwill (ASU 2014-18), and, thus, also adopted the goodwill alternative (ASU 2014-02), are not permitted to adopt the amendments in ASU 2017-04 upon issuance without following the guidance in FASB ASC 250, *Accounting Changes and Error Corrections*, including justifying why it is preferable to change their accounting policies.

Practice Note. Private companies that previously adopted the goodwill alternative for private entities may decide to adopt the amendments in ASU 2017-04. This may occur, for example, when a private entity that adopted the accounting alternative is planning to go public at some point in the future. A private company should use the remaining unamortized balance of goodwill as its new cost basis if it switches from the goodwill alternative. If that private company had elected to test goodwill for impairment at the entity level under the goodwill alternative, it should follow the guidance in paragraphs 33-38 of FASB ASC 350-20-35 and paragraphs 1-9 of FASB ASC 350-20-55 to determine an entity's reporting units. The private company should follow the guidance in paragraphs 41-44 of FASB ASC 350-20-35 to assign goodwill to those reporting units.