Memo

Memo No.	**7**
IASB Agenda ref	**18E**
Issue Date	**June 8, 2016**
Meeting Date(s)	**JtBM June 20, 2016**

Contact(s)	**Halie Creps**	Lead Author	Ext. 334
	Peter Proestakes	Assistant Director	Ext. 247
	Alexis Tanoue	Co-Author	Ext. 205

Project	**Accounting for Goodwill Impairment**
Project Stage	**Exposure Draft Comment Period**
Issue(s)	**Project Update**

Purpose or Objective of This Memo

1. The purpose of this memo is to provide a summary to the Boards of the progress to date by the FASB on the accounting for goodwill impairment project. The project is currently in the Exposure Draft comment period. This is a non-decision-making meeting.

Background Information

2. On November 25, 2013, the FASB added a project to the technical agenda and asked the staff to analyze potential alternatives for the subsequent measurement of goodwill for public business entities (PBEs) and not-for-profit entities (NFPs). The project was added to the FASB's agenda at the same meeting the FASB endorsed the Private Company Council (PCC) recommendation for private companies for the subsequent measurement of goodwill.

3. At its October 28, 2015 meeting, the FASB decided to divide the project into two phases. The first phase, which is the focus of this memo, is to simplify the current impairment test and the second phase is to determine if additional changes to the subsequent accounting for goodwill (for example, amortization) are warranted.

4. The FASB has focused on phase 1 since the last joint FASB and IASB meeting on September 23, 2015.

Simplifying the Accounting for Goodwill Impairment

5. Under Subtopic 350-20, Intangibles—Goodwill and Other—Goodwill, there is currently a two-step quantitative impairment test with an option to perform a qualitative assessment to determine if the quantitative test is necessary. The qualitative assessment requires an entity to determine if it is more likely than not that the fair value of a reporting unit[1] is less than its carrying amount. If it is, the entity moves on to the quantitative impairment test, calculating the fair value of the reporting unit including goodwill and comparing that amount with the carrying amount of the reporting unit (step 1 of the impairment test). If the carrying amount is higher, the entity must perform step 2 of the goodwill impairment test.

6. Step 2 involves calculating the fair value of each of the assets and liabilities of the reporting unit as the entity would do in a business combination, including unrecognized assets such as intangible assets. The amount by which the fair value of the reporting unit as a whole calculated in step 1 exceeds the fair value of the net assets of the reporting unit (the residual) is considered the implied fair value of goodwill. This implied amount is compared with the carrying amount of goodwill and an impairment charge is recognized for the amount by which the carrying amount of goodwill exceeds its implied fair value. The impairment charge cannot exceed the carrying amount of goodwill allocated to the reporting unit. Under current GAAP, step 1 generally indicates whether there is impairment and step 2 quantifies the amount.

7. There are several ways in which the impairment model could be simplified; however, for this phase of the project, the FASB focused solely on the removal of step 2 from the guidance.

8. Many preparers indicated that step 2 is extremely costly and complex because it requires a fair value estimate for all individual assets and liabilities (for example, intangible assets,

[1] The Master Glossary of the *FASB Accounting Standards Codification®* provides that "a reporting unit is an **operating segment** or one level below an operating segment (also known as a component)."

property, plant, and equipment). Many stakeholders note that removal of this step would not reduce the relevance of the financial statements to users because they are more interested in the existence of an impairment of goodwill rather than the exact amount of impairment and because the calculation of impairment is not well understood by users today.

9. Most stakeholders in the staff's outreach were supportive of a one-step test for impairment to the extent that an impairment test is retained. Two preparers in the staff's outreach preferred a two-step quantitative test. Both of those preparers had experience with performing step 2 of the impairment test and ultimately did not record a goodwill impairment. Thus, they note that step 2 provides a more accurate reflection of whether goodwill is impaired.

10. The elimination of step 2 is not only expected to reduce costs for reporting units for which the carrying amount exceeds the fair value (fail step 1), but also to reduce costs for those reporting units that do not have a significant excess of fair value over book value. Currently, if step 1 indicates that an impairment exists, even if the reporting unit fails step 1 by a small amount, the impairment to goodwill could be substantial. As such, auditors heavily scrutinize the assumptions used in step 1 when a reporting unit passes only by a small margin because a small change in any assumption could potentially result in a large impairment charge. By contrast, the single-step impairment test (formerly referred to as step 1) is less sensitive to changes in assumptions because a small change in any assumption is less likely to result in a significant change in the impairment charge, and, therefore, there may be less pressure on the test.

11. However, the one-step test increases the sensitivity of goodwill to impairment in periods following a partial goodwill impairment. Under a one-step test, goodwill would be impaired such that, immediately subsequent to the impairment, the fair value of the reporting unit (or whatever level is tested) equals book value. Therefore, the sensitivity of the impairment test (that is, whether it is more likely than not that goodwill is impaired) is increased when a one-step test is used. External factors, such as a minor change in discount rates, could result in additional goodwill impairment. As a result, some of the

cost savings from eliminating step 2 could be offset by higher costs in the years following the impairment.

12. Some proponents of the one-step test note that while a test may be more sensitive in future periods, unless the reporting unit's operating performance has declined, the incremental impairment often would not be material. Other proponents note that sensitivity might make the impairment charges more useful to investors because if the charge is material, it could provide evidence that management has continued to reduce its projected cash flows.

13. One accounting firm highlighted that because long-lived assets (including definite-lived intangible assets) are screened for impairment using a recoverability test rather than a fair-value-based test, a one-step test for goodwill could result in an impairment of goodwill that is actually attributable to the decline in the fair value of a long-lived asset. In other words, the long-lived asset might pass its impairment test under Topic 360, Property, Plant, and Equipment, using undiscounted future cash flows to determine recoverability, but the decline in its fair value could drive the fair value of the reporting unit below its carrying amount.

14. The same issue exists under current GAAP and is a function of the different impairment models for amortizing versus nonamortizing assets. However, today, if a long-lived asset would be impaired under a fair value test but not under a recoverability test, there might be no indication to investors because goodwill might not actually be impaired under step 2. Some could argue that recognizing goodwill impairment under the one-step test would provide more useful information to investors because there would at least be an indication in the financial statements that something has deteriorated (when there might not be any such indication under a two-step test).

15. To illustrate the issue, the following scenarios depict the effect that changes in the fair value of long-lived assets can have on the impairment charge. For the following scenarios, assume the reporting unit has fair value (FVRU) of $75 and the reporting unit has a carrying value (CVRU) of $100 ($50 long-lived assets, $100 goodwill, and -$50 liabilities). An impairment test on the long-lived assets is required because of a triggering event that resulted in a recoverable amount of $60 based on undiscounted cash flows. No

impairment is recognized on the long-lived assets because the recoverable amount exceeds the carrying amount of those assets. Step 2 of the goodwill impairment test must be performed because the fair value of the reporting unit is less than its carrying value. Based on the step 2 valuation, the fair value of the liabilities (FVL) is $50.

Scenario	**1**	**2**	**3**
Fair value of long-lived assets (FVLLA)	$40	$75	$15
Implied fair value goodwill (FVRU-FVLLA+FVL)	$75-$40+$50 =$85	$75-$75+$50 =$50	$75-$15+$50 =$110
Is the implied fair value of goodwill less than its carrying amount of $100?	Yes	Yes	No
Amount of goodwill impairment (carrying amount of goodwill-implied fair value goodwill)	$100-$85 =$15	$100-$50 =$50	N/A

(a) Under scenario 1, the entity would recognize a goodwill impairment of $15 even though $10 ($40 FVLLA - $50 carrying amount of long-lived assets) is actually attributable to the decline in value of the long-lived assets.

(b) Under scenario 2, the entire goodwill impairment charge would be attributable to goodwill because the fair value of the long-lived assets exceeds their carrying amount.

(c) Under scenario 3, the entity does not recognize a goodwill impairment because the implied fair value of goodwill exceeds the carrying amount of goodwill. Additionally, because the long-lived assets passed the recoverability test under Topic 360, there would be no impairment recorded for those assets either, even though the carrying amount of the long-lived assets exceeds their fair value by $35 ($15 FVLLA - $50 carrying amount of long-lived assets).

(d) By removing step 2 of the impairment test, the impairment charge calculated under all three scenarios above is $25 ($75 FVRU - $100 CVRU).

16. The FASB discussed another issue with a one-step test. Without a second step of the impairment test, if the carrying value of a reporting unit was zero or negative, the fair value would almost always be higher than the carrying amount, and such entities could get a "free pass" on impairment. Under current GAAP, an entity is required to perform step 2 for a reporting unit if it has a zero or negative carrying value and meets certain factors that indicate that goodwill is more-likely-than-not impaired.

17. The FASB issued proposed Accounting Standards Update, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment*, on May 12, 2016. Comments on the amendments in that proposed Update are due July 11, 2016.

18. In that proposed Update, the FASB is proposing to remove step 2 of the impairment test. Under the proposed amendments, an entity would perform its annual, or any interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity generally would recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, that amount should not exceed the carrying amount of goodwill allocated to that reporting unit. An entity would still have the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary.

19. The FASB elected not to require a different analysis or model for reporting units with zero or negative carrying amounts, but is proposing a new disclosure requirement to identify any reporting units with zero or negative carrying amounts and the amount of goodwill allocated to them.

20. The proposed Update includes questions for respondents on specific aspects of the proposed amendments, as well as a question on whether additional changes should be made to the subsequent accounting for goodwill to meet the FASB's objective of reducing the cost of the current model while maintaining the usefulness of the information provided to users of financial statements.

Next Steps

21. When the comment period has closed for the proposed Update, the staff will summarize the feedback received and make recommendations to the FASB for a final Accounting Standards Update.

22. The FASB also may use feedback from the proposed Update to form views on whether and what additional changes to the subsequent accounting for goodwill are warranted under phase 2 of the project.