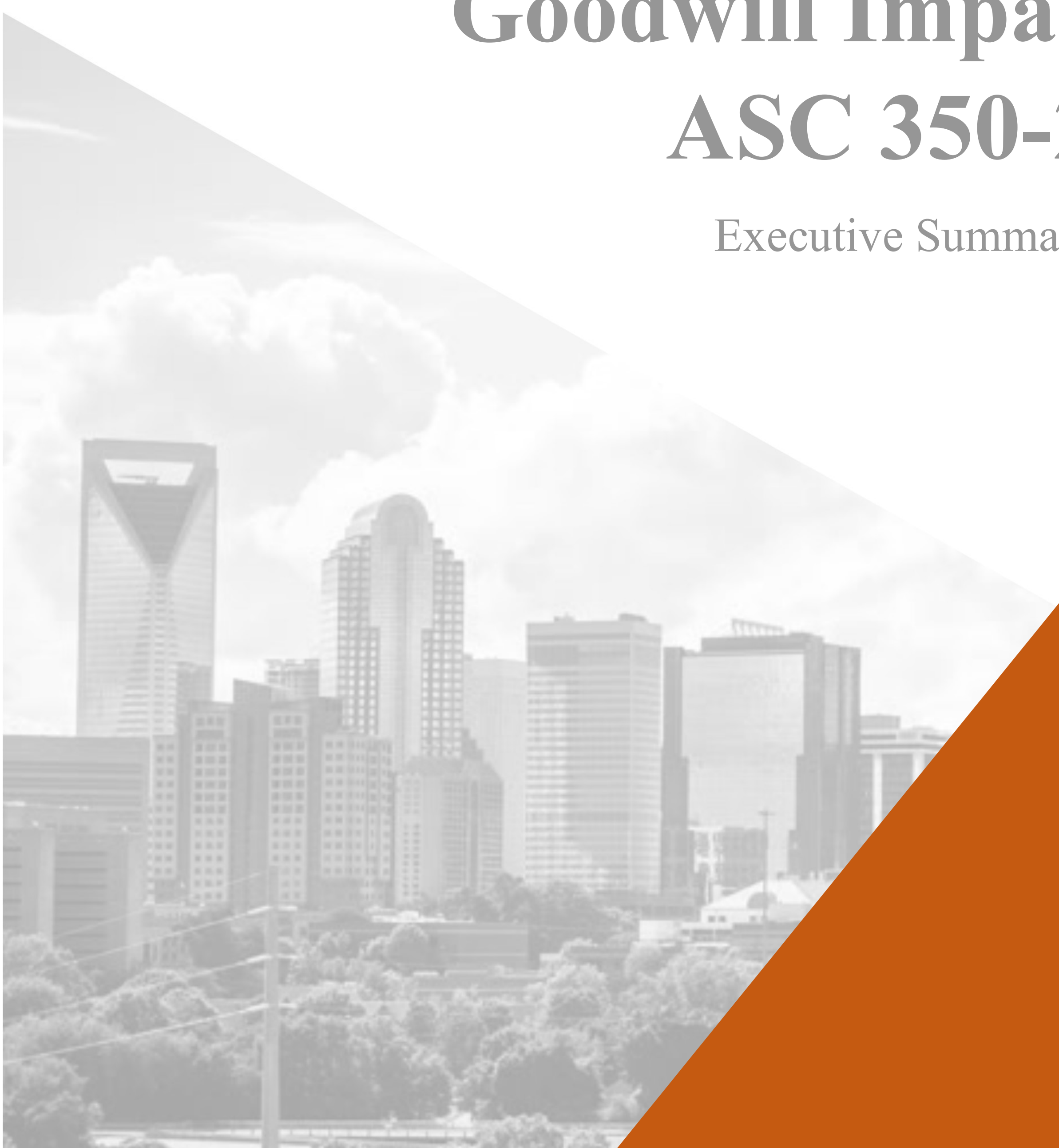
TBH Consulting LLC

Goodwill Impairment: ASC 350-20

Executive Summary



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I. Introduction

ASC 350 *Intangibles–Goodwill and Other* provides measurement, recognition, and disclosure guidance for the impairment of goodwill.

Goodwill is created as a result of a business combination under ASC 805 or an acquisition of a not-for-profit under ASC 958. The excess of the purchase price over the net identifiable assets represents total goodwill arising from the transaction. This balance is presented in the long-term assets section of the balance sheet and is classified as an indefinite-lived asset.

History and current state

The goodwill accounting model was first introduced in 2001 by the FASB and has evolved significantly over the years through the issuance of numerous Accounting Standards Updates. The publishments were intended to simplify the performance of goodwill impairment testing.

ASU 2011-08 was the first to introduce the optional qualitative assessment (Step 0 of the goodwill impairment test).

In 2019, ASU 2017-04 stated that ALL entities were no longer required to compute implied fair value (Step 2 of goodwill impairment test).

Historically, arguments have been made over whether Goodwill is truly an indefinite lived intangible. Starting in 2018, deliberations were made over whether to move to an amortization rather than impairment model for goodwill. However, in 2022 the FASB elected to not reassess or change the goodwill accounting model. According to the Board, the project was removed from the agenda due to an unclear need for change.

ASU 2023-05 was released in 2023 with the intent to reduce diversity in practice of accounting for joint venture formation. Historically, a joint venture formation was considered outside the scope of ASC 805. With this update, joint ventures will be required to measure and recognize assets and liabilities at their fair value. Existing joint ventures have the option but are not required to apply this guidance retrospectively. This standard takes effect and applies to all joint ventures with a formation date on or after January 1, 2025.

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Under ASU 2023-05, goodwill will be recognized as the excess of the joint venture's fair value over its identifiable assets and liabilities in accordance with Topic ASC 805-60.

Scope and exclusions

In accordance with ASC 350, goodwill shall be evaluated for impairment on an annual basis. Annual impairment testing is a requirement for all public companies. Elected alternatives are available for private companies and not-for-profits, which are expanded upon in Section VI. Goodwill is considered impaired when its value declines below the purchase price. In that case, goodwill is written down and an impairment loss is recognized.

ASC 350-20-25-3 specifies certain costs that should be expensed as incurred and thus excluded from goodwill subject to annual impairment testing. These costs include those that are internally developing, maintaining, or restoring intangible assets (including goodwill), are not specifically identifiable, have indeterminable lives, or that are inherent to continuing business operations.

Goodwill accounting models

ASC 350-20 allows for goodwill to be accounted for under two distinct models:

General Accounting Model

Required for public companies, goodwill shall be tested annually for impairment at the reporting unit level, or between annual tests when impairment indicators exist. Triggering events must be monitored throughout the period.

Goodwill Accounting Alternatives

Available to private companies and NFPs, goodwill may be amortized over a 10-year (or less) useful life and tested for impairment at the entity or reporting unit level only when indicators exist. Triggering events can be assessed at the end of each interim or annual reporting period.

Goodwill impairment test

At least annually, and more frequently upon the occurrence of a triggering event or impairment indicator, public companies are required to follow the goodwill impairment test.

0 **Optional Qualitative Assessment**
- Is the reporting unit fair value more likely than not less than its carrying amount?
- If **YES**, proceed to Step 1

1 **Quantitative Assessment**
- Is the reporting unit fair value less than its carrying amount?
- If **YES**, recognize goodwill impairment for the difference

2 **Quantitative Assessment**
- **Eliminated** by ASU 2017-04
- If carrying value of goodwill exceeded the implied fair value of goodwill, impairment was recognized for the excess

As noted in the history above, the Accounting Standards Updates issued in 2011 and 2019 simplified the testing for goodwill impairment. Step 0 is an optional qualitative assessment that may result in the bypassing of Step 1 analysis. The optional qualitative assessment determines whether it is more likely than not that the fair value of the reporting unit is greater than the carrying amount. If it is more likely than not that the fair value is greater than the carrying value, Step 1 can be bypassed. If there are qualitative indicators for impairment, the entity should proceed to Step 1.

To perform periodic testing of goodwill in Step 1, a reporting entity must:

- Identify its operating segments,
- Identify its reporting units,
- Assign assets and liabilities to its reporting units,
- Assign all goodwill to one or more of its reporting units, and
- Compare fair value of the reporting unit to the carrying amount to determine whether impairment exists as part of the quantitative assessment.

II. Identifying the Goodwill Testing Level

For public companies, ASC 350-20 requires all goodwill to be assigned to one or more reporting units, each of which must be tested for goodwill impairment at least annually and more frequently when impairment indicators exist. Since the issuance of ASU 2014-02, private companies or NFPs may elect to test goodwill at the reporting unit level, continuing to follow ASC 350-20 guidance, or may elect to test at the entity level.

Operating segments and reporting units

ASC 350 states that ASC 280 *Segment Reporting* can be used as a guideline to determine the reporting units of an entity. A reporting unit is an operating segment or one level below an operating segment, which ASC 280 refers to as a "component". An operating segment is the highest level that can be a reporting unit within the company while a component is considered to be the lowest.

Per ASC 350-20-35-34, a component of an operating segment is required to be identified as a reporting unit if the component is a business for which discrete financial information is available and segment management regularly reviews the operating results. Once components are identified, reporting entities should consider whether any components of an operating segment should be aggregated into one or more reporting units based on whether the components have similar economic characteristics as permitted by ASC 280-10-50-11. In some cases, an operating segment may represent a reporting unit.

(Further details can be found in TBH Insights - Segment Reporting).

Reporting unit assignment

Goodwill must be allocated to identified reporting units before a qualitative or quantitative test can be performed.

The carrying amount of each reporting unit is determined by assigning the assets, including goodwill, and liabilities to each unit.

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For reporting entities subject to ASC 740 requirements, deferred income taxes are included in the reporting unit (or entity) carrying amount, regardless of which accounting model is used (general goodwill or accounting alternative).

Identification of impairment indicators

An impairment indicator or triggering event for goodwill requires the reporting entity to consider the facts and circumstances surrounding the possible causes of impairment. Ultimately, judgment and the consideration of the combined effect of all indicators will be critical when determining whether there is a potential for goodwill impairment.

ASC 350-20-35-3C lists examples of triggering events that may lead to goodwill impairment:

1. Macroeconomic conditions
2. Industry and market considerations
3. Cost factors
4. Overall financial performance
5. Entity-specific events
6. Events affecting a reporting unit
7. A sustained decrease in share price

This list of triggering events is not complete as adverse changes to normal business operations apart from the above list may result in an impairment indicator.

III. Goodwill Assessments

Optional qualitative assessment (step 0)

Entities are not required to calculate reporting unit fair value (Step 1 assessment) unless it is more likely than not (more than 50%) that it is less than the carrying amount. The potential for impairment is determined in the qualitative assessment followed by the recognition of a loss, given that an impairment exists.

The qualitative assessment consists of evaluating relevant market events, industry factors, litigation, financial performance, and other circumstances (triggering events/ impairment indicators) to determine if there is a potential for impairment.

When evaluating macroeconomic conditions, management should assess access to capital, fluctuations in foreign currency, inflation, or other deterioration to the overall environment. Management should consider industry and market specific circumstances and evaluate changes in competition, regulatory requirements, or a decline in market demand for certain products can significantly impact the reporting unit. When assessing cost factors, management should consider any supply chain delays, labor shortages, and increased prices for raw materials and how the changes impact future cash flows. The combination of factors that influence the overall financial performance of a reporting unit may be assessed through the comparison of projected to actual results and evaluating key metrics. Further, the health of the entity may be reflected through changes in management and key personnel, loss of customers and other situations suggesting a going concern. A more likely than not possibility of selling or disposing of a portion or all of the reporting unit may represent an adverse event. Finally, a sustained decrease in share price to the entity and benchmark comparison to others in the industry may indicate impairment.

When there are no qualitative indicators for impairment, the assessment is complete and management does not continue to Step 1. When qualitative indicators of impairment do exist, a reporting entity must proceed to Step 1 and perform a quantitative assessment.

Per ASU 2011-08, this Step) approach is optional, and entities may begin testing with the quantitative assessment in Step 1. In some cases, companies opt to proceed to Step 1 due to Step 0 requiring more effort than the quantitative analysis alone. Private companies and NFPs that elect to amortize goodwill over 10 years or less must perform an assessment at least annually to see whether impairment indicators are present or more frequently if a triggering event occurs.

Quantitative assessment (step 1)

If electing to bypass the qualitative assessment in Step 0, a reporting entity must proceed directly to the quantitative test for Step 1. If Step 0 was performed and it is determined that goodwill may be impaired, progression to this step is also required.

The quantitative goodwill impairment test is as follows:

1. An entity must first determine the fair value of the reporting unit and compare it to the reporting unit's carrying value. Based on this comparison, goodwill impairment should either be recognized or remain unchanged in the financial statements.
2. If the fair value of the reporting unit is less than the carrying value and the difference between the fair value and carrying value exceeds allocated goodwill, the entire carrying amount of goodwill should be written off via impairment. If the difference between fair value and carrying value does not equal or exceed the allocated goodwill, impairment should only be recognized for the difference.

Fair value determination

Reporting entities must be in compliance with ASC 820 when determining the fair value of the entity or reporting unit. According to ASC 350-20-35-22, the fair value of a reporting unit is the price that the entire unit may be sold for, amongst market participants, on the measurement date. While quoted market prices in active markets are a helpful basis, the codification caveats that the market price of an individual equity security may not be appropriate or representative. Management must consider the context of the sale and resulting synergies that add value to the entity as whole. These additional factors may drive a higher price for an entity obtaining control compared to what an individual shareholder may perceive in the market.

Management judgment will play a significant role in the determination of fair value. An appropriate valuation technique must be utilized, such as one based on multiples of earnings or revenue. Common methods include the market, income, and cost approach. Companies must also consider synergies resulting from an acquisition, economic and business indicators present, and the overall financial performance of the reporting unit. Finally, tax impacts should be taken into account depending on whether the goodwill originally resulted from a transaction that is non-taxable.

1) Reporting unit FV > reporting unit CV
- No goodwill impairment should be recognized

2) Reporting unit FV < reporting unit CV & the difference is greater than the CV of goodwill allocated to that reporting unit
- Goodwill impairment should be recognized equal to the carrying amount of goodwill allocated to that unit.

3) Reporting unit FV < reporting unit CV & the difference is less than the CV of goodwill allocated to that reporting unit
- Goodwill impairment should be recognized for the difference

IV. Measuring Goodwill Impairment

Initial measurement

According to ASC 350-20-35-77, any goodwill impairment loss should be allocated to the individual amortizable units of goodwill of the reporting unit (or entity) pro rata based on their relative carrying amounts or another reasonable basis.

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The level at which a reporting entity has elected to test goodwill for impairment determines how the goodwill impairment loss is allocated.

At the entity level, the loss is allocated over all amortizable units of goodwill. Whereas if electing to test at the reporting unit level, the loss is allocated to the amortizable units of goodwill of the reporting unit. The reversal of a goodwill impairment loss is prohibited.

Subsequent measurement

For all public companies, the adjusted carrying amount for goodwill should continue to be assessed annually for further impairment. For private companies or NFPs electing the alternative, after the impairment loss is recognized, the adjusted carrying amount of goodwill should be amortized over its remaining useful life. The subsequent reversal of a previously recognized goodwill impairment loss is prohibited.

V. Presentation and Disclosure

If material to the financial statements, goodwill impairment losses are recognized as a separate line item on the statement of operations before the subtotal of income from continuing operations, unless associated with a discontinued operation and included within the results of discontinued operations, according to ASC 350-20-45-2 and 3.

The recognized goodwill impairment loss must also be disclosed in the notes to the financial statements that include the period in which the loss is recognized. The notes to the financial statements must include the following:

ASC 350-20-50-2

1. Description of the facts and circumstances leading to impairment
2. Amount of impairment loss and method of determining FV of the reporting unit

In accordance with ASC 350-20-50-1, entities that report segment information in line with topic ASC 280 are required to disclose goodwill roll forward information detailing the changes in the carrying amount of goodwill during the period. Fair value disclosures are also required under ASC 820.

Additional goodwill impairment disclosures surrounding accounting estimates may also be requested by the SEC, particularly for 'at risk' reporting units. These disclosures may include:

- Goodwill amount allocated to the reporting unit,
- Methods and key assumptions, including how they were determined,
- Percentage by which FV exceeded BV, and
- Events and circumstances that could negatively affect the key assumptions.

For private companies or NFPs electing the goodwill alternatives defined below, a disclosure should be made in the significant accounting policies section of their financial statements.

VI. Goodwill Accounting Alternatives

Private companies

In January 2014, ASU 2014-02 was issued to offer private companies alternatives to accounting for and subsequently measuring goodwill. Private companies have the option of amortizing goodwill on a straight-line basis over a 10-year or less useful life and testing for impairment at the entity or reporting unit level.

ASC 350-20-35-65 stipulates when amortizing goodwill, the remaining useful life may be subsequently changed so long as the amortization period does not exceed 10 years. If the estimate is revised, the carrying amount will be prospectively amortized using the new remaining useful life on a straight-line basis.

If impairment tests of assets other than goodwill are both performed at period end, other assets must be tested prior to performing goodwill impairment assessment.

(Further details can be found in TBH Insights - Impairment).

Not-for-profit organizations

ASU 2019-16 was released to extend the goodwill accounting alternatives available to private companies to all NFPs. By this time, ASC 2017-04 had been issued, eliminating Step 2 of the goodwill impairment test for all entities.

In March 2021, the issuance of ASU 2021-03 permitted private companies and NFPs the option to monitor and test for impairment only when impairment indicators exist. Triggering events are permitted to be assessed at the end of an interim or annual reporting period. Assessment is still required at least annually and when triggering events arise.

Election considerations

Before making an accounting alternative election, private entities are encouraged to consider prospects for becoming a public company in the future as they would be required to retrospectively remove the effects of the alternatives in any financial statements filed with the SEC as a public company, which could become increasingly costly and complex.

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