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Accounting for Goodwill: Simplification Adds Complexity

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Abstract:
This article includes a brief history of accounting for Goodwill leading to research results regarding potential unresolved measuring and reporting issues. The debate over accounting goodwill has been ongoing for decades. The standards have been revised over these decades. Amortization of Goodwill over no more than 40 years was allowed starting in the 1970s. The Financial Accounting Standards Board (FASB) issued Statement 142 in 2001 eliminating the option to amortize and required the impairment method be applied to Goodwill. The change for simplification as promulgated in Accounting Standards Update (ASU) 2017-04 Intangibles – Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment was not welcomed by all. The lack of agreement indicates that more revisions will occur. This article reports research focused on examining the decision and views of various companies regarding the ASU 2017-04 guidance based on comment letters. The comment letters are available on the FASB website (FASB, 2016a).

Keywords: *Goodwill, intangible asset, amortization, goodwill impairment, FASB standards, IFRS*

1. Introduction

1.1. Accounting for Goodwill

Accounting for goodwill is a topic of controversy. Over the years there have been multiple revisions, updates, amendments and new regulations. Goodwill in the accounting perspective is the amount paid in excess of fair value of identifiable net assets in a business acquisition. This article presents the different changes made and the regulations introduced relative to the topic of Goodwill such as the Statement of Financial Accounting Standards (SFAS) 142, proposition by the Private Company Council (PCC) in 2013, and Accounting Standards Update (ASU) 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment issued by FASB.

The FASB introduced accounting regulations SFAS 142 to improve the relevance, representational faithfulness, and comparability of financial reporting. In 2001, the FASB implemented SFAS 142 stating that Goodwill cannot be amortized and will not be considered as an amortizable asset. Earlier in 2013, the FASB approved a decision proposed by the PCC to offer non-public businesses an accounting alternative to choose to amortize Goodwill and perform a simplified impairment test.

Prior to the PCC deciding and recommending to the FASB that private companies could have the option of amortizing Goodwill over 10 years, many individuals and organizations advocated for 15 years so as to be consistent with the United States Federal Tax regulations (Gray & Jorge, 2015). Diversity in accounting for Goodwill has been long debated with the Impairment Method used by public companies introducing the possibility of Goodwill having an indefinite life (Gray, Jorge, & Rodriquez, 2016).

In 2017, The FASB issued Accounting Standards Update 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment. However, the new regulation has met sharp criticism primarily due to the option for high levels of managerial discretion it created. Such a prospect may lead to the utilization of accounting for Goodwill in an opportunistic practice.

1.2. History

Based on the Accounting Principles Board (APB) Opinion No. 17 Intangible Assets as issued in 1970, the amortization of Goodwill could be done over its estimated useful life not to exceed 40 years. In 2001, the opinion was replaced by SFAS 142 Goodwill and Other Intangible Assets. It eliminated Goodwill amortization for financial reporting purposes. The SFAS 142 required the annual impairment testing of goodwill using a two-step process (FASB-Project Update, 2016c). The simplification of impairment testing was retaken into consideration due to concerns about the cost and complexity of testing for impairment. Intangible assets that are acquired individually or with a group apart from a business combination are initially recognized and measured based on the cost to the acquiring entity. Goodwill can only be recognized in a business combination (Ernst & Young, 2017a). However, with the impairment method there is an implication that Goodwill is created over time resulting in Goodwill having an indefinite life.

The elimination of step 2 in the impairment process was a change in the measuring and reporting of Goodwill. Eliminating step 2 was presented as simplifying the measurement and reporting of Goodwill. It potentially impacts all organizations that report Goodwill on financial statements. Organizations that are U.S. Securities and Exchange Commission (SEC) filers should adopt the amendment for annual or interim Goodwill impairment tests beginning after December 15, 2019. A business that is not required to file financial reports to the SEC have until December 15, 2020 to change the measurement and reporting process. Other organizations including not-for-profit have until December 15, 2021 for the updates go into effect (FASB-Accounting for Goodwill Impairment, 2017).

The guidance requires the companies to disclose the amount of Goodwill allocated to reporting units with zero or negative carrying amounts. With this, taxable business combinations can generate goodwill, which is deductible for tax. When such Goodwill is impaired, it may impact deferred taxes. In such cases, an equation method is to be used to determine the impairment loss and the income tax benefits associated with it. It is also the same method used to determine the final goodwill and related deferred income tax for nontaxable business combination (PWC, 2017a). All the four major Certified Public Accounting (CPA) firms (i.e., Ernst & Young LLP (EY), PricewaterHouse Coopers LLP (PWC), Deloitte & Touche LLP (Deloitte), and Klynveld Peat Marwick Goerdeler LLP (KPMG)) accepted the change per their Comment Letters as discussed later in this article. All four stated that the reduction of costs and complexity as the primary benefit of the amendment in impairment testing.

1.2. U.S. GAAP and IFRS

Under the U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS), Accounting Standards Codification (ASC) 350 and both International Accounting Standard (IAS) 36 – Impairment of Assets, and IAS 38 – Intangible Assets are the primary sources of guidance for the recognition, measurement, amortization, and impairment of Goodwill. Differences in the two standards can lead to significant variations in the perspective of Goodwill impairment and the amount to be written off in the U.S. and other countries. The valuation method and historical and cultural differences also contribute to the differences in the impairment accounting. To sort the differences, the International Accounting Standards Board (IASB) and the FASB continue to work on the convergence of the IFRS and U.S. GAAP (Deloitte, 2013).

Under both U.S. GAAP and IFRS, if there are changes in the long-lived assets, which could affect the recoverability of the carrying amount, then the company should test for impairment using an impairment indicator. The company should also group the long-lived assets with other assets at the lowest level of identifiable cash flows. The lowest level of identifiable cash flows is termed as asset group under U.S. GAAP. It is named as a cash-generating unit (CGU) under IFRS (Impairment of long-lived assets to be held and used or to be disposed of by sale: Key differences between U.S. GAAP and IFRSs, 2017). Goodwill accounting under IFRS relies on management estimates in many stages of impairment testing.

In May 2016, the FASB proposed simplifying the accounting for Goodwill impairment to reduce the cost and complexity of the Goodwill impairment test. The IASB also considered improvements to the requirements of Goodwill impairment. The IASB and FASB have temporarily planned to make a joint decision on these issues (Ernst & Young, 2016b, p. 24).

1.3. Tax Accounting Aspects

Goodwill impairment standards are updated, and amendments have been made to it over the years. With the new guidance, companies are required to disclose the amount of Goodwill that is allocated to the reporting units with zero or negative carrying amounts. Although taxable business combinations generate Goodwill that is deductible for tax, when the Goodwill is impaired it may impact on deferred tax (PWC, 2017a).

According to the FASB's ASC 350-35-20, to determine the implied fair value of Goodwill the company can use the income tax base of the reporting unit's assets and liabilities. The company can use the existing income tax base if the assumed structure used to estimate the fair value was a nontaxable transaction or use the new base if it is a taxable transaction. Prior to the estimate of fair value of the reporting unit, the entity should determine if the estimate based on the type of transaction, non-taxable or taxable.

For the determination, the entity should consider the following:

- Whether the assumption is consistent with those that marketplace participants would incorporate into their estimates of fair value
- The feasibility of the assumed structure
- Whether the assumed structure results in the highest and best use and would provide maximum value to the seller for the reporting unit, including consideration of related tax implications (ASU 350-35-26, 2017).

For the determination of the nontaxable transaction, the company should consider the following factors among other factors:

- Whether the reporting unit could be sold in a nontaxable transaction
- Whether there are any income tax laws and regulations or other corporate governance requirements that could limit an entity's ability to treat a sale of the unit as a nontaxable transaction (ASC 350-35-27, 2017).

When Goodwill is based on the equity method investment, if the equity method investee recognizes a Goodwill impairment loss the investor should consider whether the carrying amount of the investee might be impaired. The FASB issued ASU 2017-04, Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. It simplifies the accounting for Goodwill impairment to reduce the cost and complexity of the Goodwill impairment test. The new impairment test only requires a single-step quantitative test; the qualitative assessment remains optional and

unchanged. The Accounting Standards Codification (ASC) does not change the qualitative assessment, but the new guidance requires the companies to disclose the amount of Goodwill allocated to reporting units with zero or negative carrying amounts (PWC, 2017a). Yet the simplification process had its share of controversy. The single step may be simpler, but it can also mean the single step is less precise, and other assets may drive the Goodwill impairment in the reporting unit (PWC, 2017b).

1.4. Potential Unresolved Accounting Problems

Accounting for Goodwill is a continuously amended area of focus, and a current policy may seem like the right solution to some, but it may not be the case for others. Issues that may be seen in the future on the topic of Goodwill could probably be on internally generated intangible assets, which have been left off the balance sheet due to the possibility of being counted twice. Another concern is regarding intangible nature of brands and the difficulty it causes in the valuing accurately. Since the financial transactions involved in brand growth cannot be tracked, it increases the difficulty level of valuation. The value of the Goodwill may or may not change over the years, and that questions the impairment approach. When the value relevance of Goodwill differs and becomes less as it grows older, then the Goodwill impairment method will be a concern for investors and regulators (Bepari & Mollik, 2017).

Since the Goodwill impairment charge would impact the measurement and reporting of deferred taxes. The method of Goodwill measurement may change or request for change may be proposed in the future (Ernst & Young, 2017b).

1.5. Companies' Perspectives on Simplifying Goodwill Impairment

A total of 30 companies' Comment Letters were randomly chosen for the study to understand their perspectives and stance on the guidance. Many of the companies agree with the proposed amendments to eliminate Step 2 from the impairment test. The majority believed that the requirement to perform Step 2 should not be retained as an option due to the possibility that it could lead to complexity and reduces the consistency in the financial statements. However, few companies are in favor of the retaining the step, as it would enable companies to select between more precise methods of impairment while providing flexibility to companies that prefer a simplified method.

2. Conclusion

It has become essential for the investors and other users of the financial statements to understand how companies measure and record Goodwill. It is the amount paid for the business in a business combination or acquisition where there is a difference that can be recognized as an overpayment or a discount from the actual price. Goodwill should be evaluated for impairment annually. Goodwill being an intangible asset is a representation of the future benefit, and appropriate recognition, measurement, and management are necessary.

The FASB's mission and the objectives are to expand and improve financial reporting. Financial reporting consistency is a continuously evolving process. As of now, there are differences, and the updates raise questions on the process and the financial obligation it creates for businesses. The FASB's ASC 350 is part of the initiative to the unification and the improvement of standards for intangibles. The Overview and Background Sections of Subtopics 350-10, 350-20, 350-30, and 350-40 involves goodwill, intangible assets, certain software costs, and website development costs. Goodwill and intangibles have been amended over the years. FASB Statement 142 was supported by many stakeholders, but did question the practicability of the concept and if another method would be more appropriate. In 2011, another concern regarding the cost and complexity in the annual two-step goodwill impairment test was raised, and in 2017 FASB issued Accounting Standards Update 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment. The changes made over the years are a reason why financial statement users are concerned about the consistency in the reporting.

3. Summary

Accounting for Goodwill has been and continues to be a topic of controversy. Over the years there has been multiple revisions, updates, amendments and new regulations. The subject of Goodwill gained its attention with the growth and importance of intangible assets. Goodwill is a challenging element and is a significant portion of the company's balance sheet. Goodwill is also an essential factor in determining the value of the company.

In August 1970, The Financial Accounting Standards Board (FASB) issued the Accounting Practice Board (APB) Opinion No. 17 - Intangible Assets as guidance in the treatment of intangibles. According to the Opinion, purchased intangibles both identifiable and unidentifiable are to be capitalized and amortized over the estimated useful life of the asset without exceeding 40 years (FASB – APB 17, 1970, August). In 1999, the FASB issued an exposure draft of a proposed statement, which will reduce the amortization from 40 years to 20 years. In 2001, FASB issued SFAS 142 - Goodwill and Other Intangible Assets, which also requires recognizing goodwill under the purchase method, but does not require the amortization of Goodwill (FASB, 2017, January 26).

In 2017, The FASB issued Accounting Standards Update 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment. Based on the update, the optional qualitative assessment (step 0) and quantitative assessment (step 1) will remain the same, and there will not be any change to the timing of assessments.

The controversy of accounting for Goodwill will remain due to the changing economic environment, expansion, and even emergence of new technology or even opposition to current standards. Due to the various factors that can potentially impact goodwill valuation and impairment, it can be said that there are resolved issues. Also, the importance of

goodwill and other intangibles are on the rise and is of vital importance to the users of financial statements. Goodwill can often arise when one company purchases a company. The attempts to simplify measurement and reporting have created more complexities.

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