Deloitte.

April 25, 2011
Volume 18, Issue 9

Heads Up

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FASB's Goodwill Gesture

Amendments Proposed to Guidance on Impairment Testing

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In response to requests to simplify and reduce the costs of performing the annual goodwill impairment test, the FASB issued a proposed Accounting Standards Update (ASU), *Testing Goodwill for Impairment*. Under the proposed ASU, entities testing goodwill for impairment would have the option of performing a qualitative assessment before calculating the fair value of the reporting unit (i.e., step 1 of the goodwill impairment test). If entities determine, on the basis of qualitative factors, that the fair value of the reporting unit is more likely than not greater than the carrying amount, a quantitative calculation would not be needed. The proposal would not change how goodwill is calculated or assigned to reporting units, nor would it revise the requirement to test goodwill annually for impairment. In addition, the proposed guidance does not amend the requirement to test goodwill for impairment between annual tests if events or circumstances warrant; however, it does revise the examples of events and circumstances that an entity should consider. Comments on the proposal are due June 6, 2011.

Steps to Perform

Under U.S. GAAP, entities are currently required to test goodwill for impairment annually and in between annual tests if certain events or circumstances indicate that goodwill may be impaired. This test consists of a two-step process:

Step 1:

- Determine whether the fair value of the reporting unit is less than its carrying amount, including goodwill. If so, proceed to step 2.
- If the fair value of the reporting unit is greater than the carrying amount, further testing of goodwill for impairment is not performed.

Step 2:

- Determine the implied fair value of the goodwill of the reporting unit by assigning the fair value of the reporting unit used in step 1 to all the assets and liabilities of that reporting unit (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business combination.
- Compare the implied fair value of goodwill with the carrying amount of goodwill to determine whether goodwill is impaired.

Under the proposed ASU, entities would have the **option** of performing a qualitative assessment before performing the quantitative calculation of the reporting unit (step 1) required by ASC 350.[1] Under this optional qualitative assessment, entities would evaluate qualitative factors to determine whether it is more likely than not (i.e., a likelihood of more than 50 percent) that the fair value of the reporting unit is less than the carrying amount. If so, they would proceed to step 1 of the goodwill impairment analysis in ASC 350-20. However, if it is more likely than not that the fair value of the reporting unit is greater than the carrying amount, further testing of goodwill for impairment would not be performed. The qualitative assessment is optional — entities may, at their discretion, bypass it for any reporting unit in any period and begin their impairment analysis with the quantitative calculation in step 1. In addition, an "entity may resume performing the qualitative assessment in any subsequent period."

Editor's Note: The FASB decided to give entities the option to perform the qualitative assessment in response to constituents that felt it would be a best practice to perform the quantitative fair value calculation annually. In addition, because other constituents indicated they would want to "refresh" their fair value calculation periodically to use it as a baseline in their assessment of the qualitative factors, the proposed ASU would allow entities to skip directly to the quantitative calculation without the burden of documenting (and being subject to audit procedures on) the qualitative factors. However, the FASB notes in the proposed ASU's Basis for Conclusions that the guidance in the proposed ASU "would adequately reduce the risk that an entity may omit a goodwill impairment loss or may not record the impairment loss in a timely manner" and that "requiring an entity to perform the first step of the two-step impairment test, even when it concludes it is more likely than not that the fair value of a reporting unit is greater than its carrying amount, would result in unnecessary costs and would conflict with the benefits of applying a qualitative approach."

Under the proposed ASU, entities would have the option of performing a qualitative assessment before performing the quantitative calculation of the reporting unit (step 1) required by ASC 350.

Qualitative Assessment Factors

Under the proposed ASU, entities would consider the following factors in their qualitative assessment:

a. Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets

b. Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline (both absolute and relative to its peers) in market-dependent multiples or metrics, a change in the market for an entity's products or services, or a regulatory or political development

c. [I]ncreases in raw materials, labor, or other costs that have a negative effect on earnings

d. Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings

e. [E]ntity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation

f. Events affecting a reporting unit such as a change in the carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing all or a portion of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit

g. If applicable, a sustained decrease (both absolute and relative to its peers) in share price.

These factors are not meant to be all-inclusive. Entities should also consider:

- The significance and adversity of each factor relative to the fair value of the reporting unit.
- Positive factors and mitigating circumstances that may affect the analysis.

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

- If the entity has a recent fair value calculation for the reporting unit, whether the fair value of the reporting unit exceeded its carrying amount by a substantial margin.
- The factors in their totality. No one factor is meant to be a determinative event that triggers a quantitative calculation. Further, "the existence of positive and mitigating events and circumstances is not intended to represent a rebuttable presumption that an entity should not perform the first step of the goodwill impairment test."

The proposed ASU would also amend the guidance on performing an interim test of goodwill. ASC 350-20-35-30 currently provides examples of events and circumstances indicating when it is more likely than not that the fair value of a reporting unit is less than the carrying amount. The proposal replaces such examples with the factors noted above for the qualitative assessment.

Carryforward Option Removed

Currently, under ASC 350-20-25-29, an entity's detailed calculation of the fair value of the reporting unit may be carried forward from one year to the next if certain conditions are met. The carryforward alternative was meant to address some of the concerns related to the cost of the annual quantitative calculation. However, the proposed ASU's Basis for Conclusions indicates that the "Board has since learned that, in practice, many nonpublic and public entities have not used the option to carry forward a reporting unit's fair value calculation."

The proposed ASU would delete the carryforward guidance in ASC 350-20. Therefore, entities currently using this option would need to assess whether to perform the qualitative assessment or move straight to the quantitative step 1 calculation.

The proposed guidance would apply to all entities, both public and nonpublic, that have goodwill recorded on their balance sheet.

Scope of Proposal

The proposed guidance would apply to all entities, both public and nonpublic, that have goodwill recorded on their balance sheet. Its scope is limited to goodwill; the proposal would not amend the annual testing requirements for other indefinite-lived intangible assets (e.g., trade names).

Editor's Note: Some industries may have significant indefinite-lived intangible assets that are tested for impairment annually. For example, the cable industry typically has large franchise-value intangible assets, which are often accounted for as indefinite-lived intangible assets. Entities would continue to test these indefinite-lived intangible assets annually for impairment (and between annual events if facts and circumstances warrant) by calculating the fair value of the intangible asset and comparing the fair value to its carrying amount. The proposed ASU's Basis for Conclusions states, "The Board reached this decision primarily because it had not received similar concerns from preparers of financial statements about the cost and complexity of testing indefinite-lived intangible assets for impairment."

When assessing whether indefinite-lived intangible assets should be tested for impairment between annual tests, entities would continue to look to the impairment indicators in ASC 360-10-35-21 rather than to the new qualitative factors in the proposed ASU. Further, entities that currently analogize to the carryforward guidance in ASC 350-20 to carry forward a prior year's fair value calculation of their indefinite-lived intangible assets may have to reassess this practice given that the carryforward option is removed under the proposed ASU.

Reporting Units With Zero or Negative Carrying Value

ASU 2010-28[2] modified step 1 of the goodwill impairment test for reporting units with a zero or negative carrying value, stating that under such circumstances an entity should perform step 2 of the impairment analysis when it is more likely than not that goodwill is impaired. In performing this step, the entity should consider adverse qualitative factors, including the examples in ASC 350-20-35-30.

The proposed ASU would amend the examples of qualitative factors to refer to those considered in the qualitative assessment. If the carrying amount of a reporting unit is zero or negative and an entity determines it is more likely than not that a goodwill impairment exists, the entity would proceed directly to step 2 to measure the goodwill impairment loss.

Effective Date and Transition

The amendments would be effective for annual and interim goodwill impairment tests performed in fiscal years beginning after December 15, 2011. Early adoption would be permitted.

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Editor's Note: Many entities choose a date before year-end (such as October 1) to perform their annual goodwill impairment test. Although this date can be changed, public entities must file a preferability letter with the SEC indicating such revision. Therefore, entities should carefully consider the timing of a final ASU with regard to any delays in performing their annual impairment test.

Convergence With IFRSs

The proposed amendments would not affect the goodwill impairment analysis under IFRSs. Under IAS 36,[3] entities test goodwill for impairment at least annually by using a quantitative test that compares the fair value of the cash generating unit to its carrying amount. The excess of the carrying amount of the cash generating unit over the fair value is recorded as an impairment loss.

During deliberations on the project, the FASB considered but ultimately rejected a number of alternative methods for testing goodwill for impairment. In assessing the alternatives, the FASB focused on cost-benefit considerations as well as on whether the methods would result in further divergence from IFRSs. The Board concluded that the following alternatives would have resulted in the further divergence:

- Modifying the guidance to allow for increased use of the carryforward option.
- Amortizing goodwill and testing for impairment on the basis of qualitative triggers (similarly to the process under the previous guidance in APB Opinion No. 17, *Intangible Assets*, and in *IFRS for SMEs*).
- Derecognizing existing goodwill and recording new goodwill as an immediate charge to either earnings or a contra equity account as of the acquisition date.
- Testing goodwill at a higher level than a reporting unit.

[2] FASB Accounting Standards Update No. 2010-28, *When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units With Zero or Negative Carrying Amounts.*

[3] IAS 36, *Impairment of Assets.*

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