

Private Company Reporting: Accounting for Goodwill

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Executive Summary

In January 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2014-02, *Intangibles – Goodwill and Other (Topic 350): Accounting for Goodwill*. ASU 2014-02 provides private companies with an alternative for accounting for goodwill subsequent to its initial recognition. The update is based on recommendations from the Private Company Council (PCC) and is intended to simplify the subsequent accounting for goodwill while still providing useful information to financial statement users. Private companies electing the accounting alternative will amortize goodwill on a straight-line basis over 10 years, or a period of less than 10 years if they can demonstrate that another useful life is more appropriate. Upon electing the accounting alternative, private companies will be required to make an accounting policy election to test goodwill for impairment at either the entity level or the reporting unit level. Goodwill no longer will be tested for impairment annually; instead, it will be tested for impairment only when a triggering event occurs indicating the fair value of the entity (or reporting unit) may be below its carrying amount. Upon the occurrence of a triggering event, a simpler, one-step impairment test will be performed.

The accounting alternative, if elected, should be applied prospectively to all goodwill existing as of the beginning of the period of adoption, as well as to all new goodwill generated from business combinations in the first annual period beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early application is permitted, including for any annual or interim period for which financial statements have not yet been made available for issuance.

Scope

ASU 2014-02 is applicable to private companies, defined as all entities except public business entities (PBE) as defined in ASU 2013-12, *Definition of a Public Business Entity*, not-for-profit entities and employee benefit plans within scope of ASC Topics 960, 962 and 965. Entities within the scope of the ASU may elect the alternative by making an accounting policy election. The election to apply the goodwill alternative is an “all or nothing” decision—that is, all aspects of the accounting alternative must be applied to all existing and future goodwill. Private companies initially adopting the alternative do not need to establish preferability for using the alternative. However, private companies making the initial election to use the alternative in the year of adoption and who then decide to change that election in later reporting periods would have to establish preferability.

Definition of Public Business Entity

Understanding the definition of a public business entity is critical in determining which entities are not eligible to apply the accounting alternatives available to private companies.

ASU 2013-12 defines a public business entity as an entity meeting any of the following criteria:

- a) It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers) with the SEC—including other entities for which financial statements or financial information are required to be or are included in a filing.
- b) It is required by the *Securities Exchange Act of 1934*, as amended, or rules or regulations promulgated under the act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c) It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for sale of, or for purposes of issuing, securities not subject to contractual restrictions on transfer.
- d) It has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market.
- e) It has one or more securities not subject to contractual restrictions on transfer and is required by law,

contract or regulation to prepare U.S. generally accepted accounting principles (GAAP) financial statements (including footnotes) and make them publicly available on a periodic basis, *e.g.*, interim or annual periods. An entity must meet both of these conditions to meet this criterion.

It is important to note the new definition of a public business entity is broader than what previously was considered public. An entity may meet the definition of a public business entity solely because its financial statements or financial information are required to be included in a filing with the SEC, such as under Regulation S-X, Rule 3-09, *Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons*, or Regulation S-X, Rule 3-05, *Financial Statements of Businesses Acquired or to Be Acquired*, and Regulation S-X, Rule 4-08(g), *Summarized Financial Information*. When an entity's financial statements are required to be included in a filing with the SEC, those financial statements must be prepared using the same accounting principles as a public business entity, which means the entity's financial statements would need to be retrospectively adjusted to unwind any previously elected private company alternatives. In that case, the entity only is a public business entity for purposes of financial statements filed or furnished with the SEC. The entity would not be considered a public business entity for purposes of its standalone financial statements not filed or furnished with the SEC.

Recognition & Measurement

Amortization of Goodwill

Private companies electing the accounting alternative will amortize goodwill on a straight-line basis over 10 years, or a period less than 10 years if they can demonstrate another useful life is more appropriate. For example, if an entity enters into a business combination primarily for the purpose of acquiring certain machinery and equipment with a remaining useful life of seven years, it may be appropriate to amortize the goodwill over the seven-year useful life of the machinery and equipment if it chooses to do so. Although companies can identify a shorter useful life when appropriate, there is no requirement to consider a shorter life; companies can default to using a 10-year amortization period without justification.

Under the alternative, companies can revise remaining useful life of goodwill when events occur or circumstances change indicating revision of the remaining period of amortization is warranted; however, there is no requirement to do so. In any case, the cumulative amortization period should not exceed 10 years. If the remaining useful life is revised, the remaining carrying amount of goodwill should be amortized prospectively on a straight-line basis over the revised remaining useful life.

The accounting alternative applies to U.S. GAAP financial statements and does not change amortization requirements under the tax law. Companies can expect to recognize a deferred tax asset or liability due to differences in the amortization period for book and tax—a maximum life of 10 years for book versus 15 years for tax.

Impairment Testing

Upon electing the accounting alternative, private companies are required to make an accounting policy election to test goodwill for impairment at either the entity level or the reporting-unit level. Under the alternative, private companies no longer will be required to perform annual goodwill impairment testing; instead, goodwill will be tested for impairment only in the case of a “triggering event,” which indicates it is more likely than not (a likelihood of more than 50 percent) that the fair value of the entity or reporting unit may be below its carrying amount. Examples of such triggering events are listed in Appendix B. The list in Appendix B is not all-inclusive; companies should consider other relevant events and circumstances that affect the fair value of the entity or reporting unit in determining whether a triggering event has occurred.

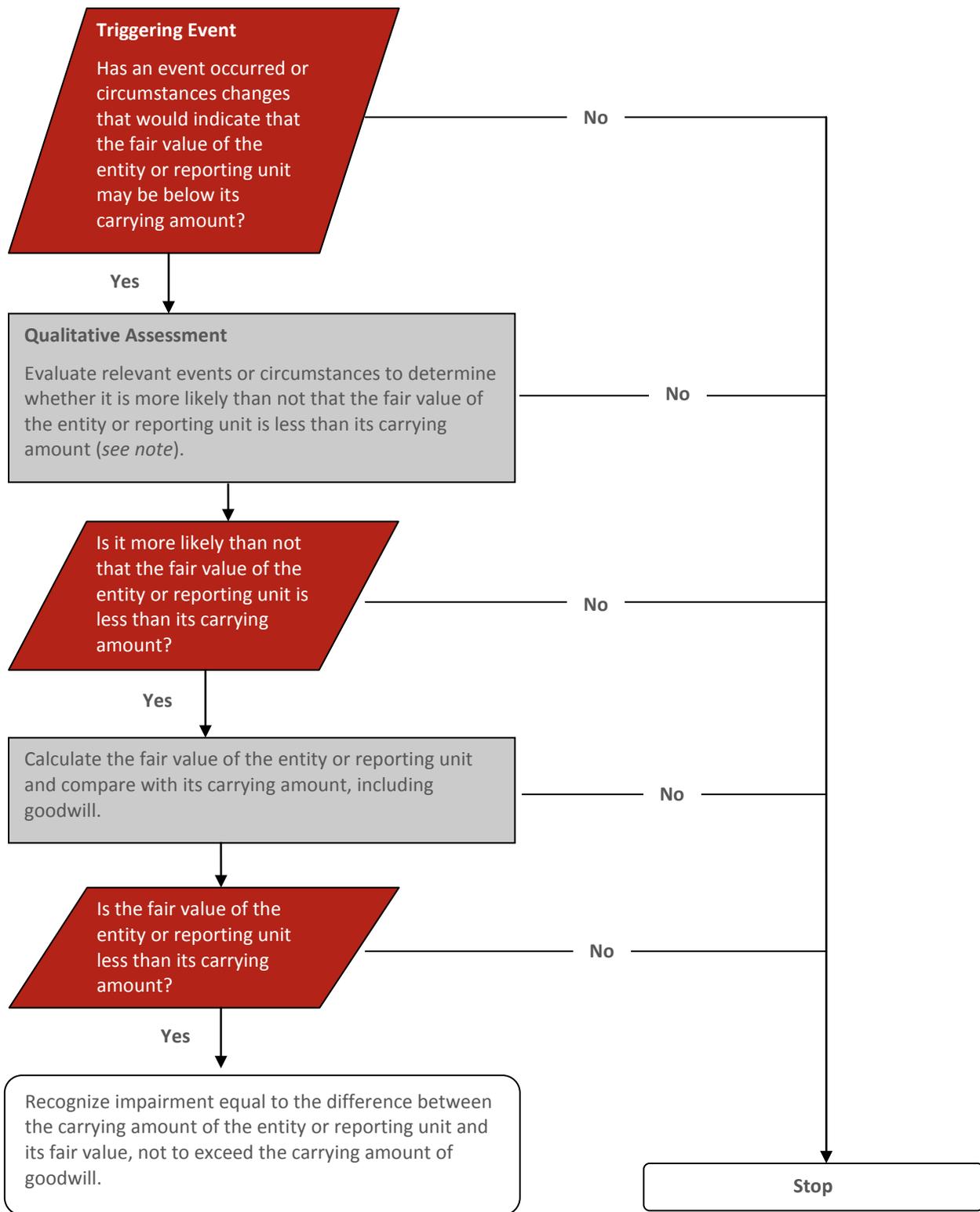
When a triggering event occurs, private companies will continue to have the option to first assess qualitative factors to determine whether it is necessary to perform the quantitative impairment test. Although the qualitative

assessment still is available to be used by companies electing the alternative, it may not be the best approach since companies already would have determined a triggering event has occurred, indicating possible impairment.

If the quantitative test is necessary, the private company would perform a simpler, one-step impairment test comparing the fair value of the entity (or reporting unit) with its carrying value. The excess carrying value over fair value, if any, would represent the impairment loss. Step Two of the goodwill impairment test, *i.e.*, the hypothetical purchase price allocation, is not required under the alternative.

Companies will allocate goodwill impairment losses, if any, to individual amortizable units of goodwill of the entity (or the reporting unit) on a prorated basis using their relative carrying amounts, or using another reasonable and rational approach. After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill should be amortized over its remaining useful life. Subsequent reversal of a previously recognized goodwill impairment loss is prohibited.

The following flowchart from ASU 2014-07 provides an overview of the accounting alternative for entities within its scope.



Note: An entity has the unconditional option to skip the qualitative assessment and proceed directly to calculating the fair value of the entity (or the reporting unit) and comparing that value with its carrying amount, including goodwill.

Although simplified, goodwill impairment testing may not be easy. The triggering criteria are subjective and require professional judgment. If a triggering event occurs, management still will need to estimate fair value of the entity or reporting unit, which may be challenging and require valuation expertise.

Disclosures

Disclosure requirements under the alternative are similar to the disclosures currently required under U.S. GAAP, except that changes in goodwill are not required to be presented in a tabular reconciliation. In addition, the disclosures required for finite-lived intangible assets would be applicable to goodwill subject to amortization. Appendix A provides a comprehensive list of presentation and disclosure requirements for goodwill accounted for under the alternative.

Transition

Private companies electing the goodwill accounting alternative should apply the guidance prospectively for goodwill recognized in annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Goodwill existing at the beginning of the period of adoption should be amortized prospectively over 10 years, or less than 10 years if the entity can demonstrate another useful life is more appropriate. Early application is permitted for any annual or interim period for which an entity's financial statements have not yet been made available for issuance. Upon adoption of the accounting alternative, an entity shall make an accounting policy election to test goodwill for impairment at either the entity level or the reporting-unit level.

Considerations for Determining Whether to Elect the Alternative

Risk of Having to Recast Financial Statements

Private companies should be cautious when determining whether to elect the accounting alternative. In making this determination, companies should consider the following:

- What is the likelihood the private company will go public or be acquired by a public company? Since FASB and the SEC have not provided any transition guidance, a private company electing the alternative that subsequently becomes a public business entity would have to retrospectively apply the accounting requirements for PBEs for all periods presented.
- Will lenders, creditors and equity investors accept financial statements that use the accounting alternative? Private companies may want to communicate with stakeholders before electing the alternative to make sure using alternative would be acceptable.

Some private companies may choose to stick with the current standard to avoid having to recast financial statements without using the alternative, as the potential cost of restatements may outweigh the interim benefits if the election is made and financial statements have to be recast.

Impact on Financial Metrics

Although the additional amortization expense that results from electing the alternative will have a negative effect on earnings, it will have no effect on EBITDA, the metric commonly used when equating profitability and efficiency ratios for a private company.

Operational Cost & Complexity Considerations

Private companies electing the alternative can anticipate annual savings in terms of human resources due to the reduced frequency and complexity of the impairment testing. Annual impairment testing will not be required; when a triggering event does warrant impairment testing, private companies may elect to perform the test at the

entity level versus the reporting unit level. Private companies also will avoid the complicated and costly exercises of determining the amount of the impairment through application of a hypothetical purchase price allocation.

Appendix A

Appendix A summarizes presentation and disclosure requirements for goodwill accounted for under the alternative.

Presentation & Disclosure Requirements Under Goodwill Accounting Alternative	
Presentation	<ul style="list-style-type: none"> ▪ The aggregate amount of goodwill, net of accumulated amortization and impairment, shall be presented as a separate line item in the statement of financial position. ▪ The amortization and aggregate amount of impairment of goodwill shall be presented in income statement line items within continuing operations unless the amortization or a goodwill impairment loss is associated with a discontinued operation. ▪ If impairment loss is not presented as a separate line item, the notes must disclose the caption in the income statement in which the impairment loss is included and the amount of the impairment loss. Likewise, if the aggregate amortization expense is not presented as a separate line item on the face of the financial statements, the notes must include the aggregate amortization expense for the period.
Required disclosures in the notes to financial statements for any additions to goodwill in each period for which a statement of financial position is presented	<ul style="list-style-type: none"> ▪ The amount assigned to goodwill in total and by major business combination or reorganization event resulting in fresh-start reporting ▪ The weighted-average amortization period in total and by major business combination or by reorganization event resulting in fresh-start reporting
Required disclosures in the financial statements or notes to the financial statements for each period for which a statement of financial position is presented	<ul style="list-style-type: none"> ▪ Gross carrying amount of goodwill, accumulated amortization and accumulated impairment loss ▪ Aggregate amortization expense for the period ▪ Certain goodwill included in a disposal group classified as held for sale and certain goodwill derecognized during the period
For each goodwill impairment loss recognized, required disclosures in the notes to the financial statements that include the period in which the impairment loss is recognized	<ul style="list-style-type: none"> ▪ A description of facts and circumstances leading to the impairment ▪ The amount of impairment loss and the method of determining fair value of the entity or the reporting unit, whether based on prices of comparable businesses, a present value or other valuation technique or a combination of those methods ▪ The caption in the income statement in which the impairment loss is included ▪ The method of allocating impairment loss to the individual amortizable units of goodwill

Appendix B

Below are examples of events and circumstances that should be considered when assessing whether a triggering event has occurred, as well as when performing a qualitative assessment to test goodwill for impairment.

Examples of Events or Circumstances that Affect the Fair Value of an Entity	
External Factor	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
External Factor	Industry and market considerations such as deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (considered in both absolute terms and relative to peers), a change in the market for an entity's products or services or a regulatory or political development
External Factor	Cost factors such as increases in raw materials, labor or other costs that negatively affect earnings and cash flows
Internal Factor	Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods
Internal Factor	Other relevant entity-specific events such as changes in management, key personnel, strategy or customers, contemplation of bankruptcy or litigation
Internal Factor	Events affecting a reporting unit such as a change in the composition or 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
Combined Factor	If applicable, a sustained decrease in share price (considered in both absolute terms and relative to peers)

For more information on how this topic could affect your organization, contact your BKD advisor.

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