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**Contributors**

Contributing Editors.....	Steven C Fustolo, CPA James F. Green, CPA
Technical Review.....	Sharon R. Brooks, CPA Nitaya Powell, CPA
Production Coordinator .....	Mariela de la Torre
Production .....	Lynn J. Brown
Layout and Design .....	Laila Gaidulis

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 4025 W. Peterson Ave.  
 Chicago, IL 60646-6085  
 800 344 3734  
 CCHGroup.com

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## Introduction

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CCH's *Top Accounting Issues for 2014 CPE Course* helps CPAs stay abreast of the most significant new accounting standards and important projects. It does so by identifying the events of the past year that have developed into hot issues and reviewing the opportunities and pitfalls presented by these changes. The topics reviewed in this course were selected because of their impact on financial reporting and because of the role they play in understanding the accounting landscape in the year ahead.

Module 1 of this course reviews ongoing issues.

Chapter 1 reviews the rules for testing impairment of goodwill and intangible assets with indefinite lives, including the new qualitative assessment option found in ASU 2012-02 and ASU 2011-08.

Chapter 2 introduces you to the framework set out in generally accepted accounting principles (GAAP) for measuring an item at its fair value.

Chapter 3 discusses the current developments in the establishment of a set of GAAP rules for private, non-public companies.

Module 2 of this course reviews financial statement reporting.

Chapter 4 discusses ASU 2011-09, which expands the required disclosures for employers that participate in multiemployer pension plans and multiemployer other postretirement benefit plans.

Chapter 5 discusses the changes that would be made to accounting for leases based on the exposure draft, and the effects those changes may have.

Chapter 6 discusses several issues that have been addressed by the AICPA, including those related to extraordinary items and involuntary conversions.

Chapter 7 discusses several practice issues including those arising from imputing good will on personal financial statements, the disclosure of policies not applicable to the current year, immaterial GAAP departures, presentation of income tax items, and OCBOA financial statements.

Module 3 of this course reviews current developments.

Chapter 8 discusses ASU 2013-04: *Liabilities (Topic 405): Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date*. It examines requirements of the ASU including the scope, disclosures, and transition rules. Numerous examples are included.

Chapter 9 discusses several ongoing issues in accounting and reporting including the proposed liquidation basis of accounting, going concern assessment by management, politically motivated disclosures, and the effects of post office changes on working capital.

Finally, Chapter 10 discusses several Accounting Standards Updates (ASUs) issued in 2012 and 2013, including ASU 2013-05 regarding foreign

## Intangible Assets with Indefinite Lives— Impairment Test Rules

This chapter reviews the rules for testing impairment of goodwill and intangible assets with indefinite lives, including the new qualitative assessment option found in ASU 2012-02 and ASU 2011-08.

### LEARNING OBJECTIVES

Upon completion of this chapter, the reader will be able to:

- Indicate how intangible assets with indefinite lives should be accounted for
- State at what level the test for impairment of goodwill is performed
- Describe events or circumstances that may warrant an interim goodwill impairment test
- Discuss the two-step test for goodwill impairment
- Explain how the rules for the qualitative assessment of goodwill impairment apply when there is a carrying amount that is zero or negative
- State how deferred tax assets and liabilities should be handled in the testing of goodwill of a reporting unit
- List the disclosures required for goodwill impairment losses

### BACKGROUND

With the current state of affairs in the U.S. economy, there are many public and non-public companies that have significant impairments of long-lived assets (equipment and real estate), goodwill, and intangible assets with indefinite lives. GAAP requires that companies test their goodwill and long-lived assets with indefinite lives annually for impairment, while long-lived asset (equipment and real estate) and intangibles with finite lives must test for impairment only if there is a reason to do so.

A typical acquisition includes the recording at fair value of long-lived tangible assets (equipment and real estate), long-lived intangibles with indefinite lives (such as licenses, tradenames and trademarks), intangibles with finite lives (such as patents), and, finally, goodwill.

ASC 805, *Business Combinations* (formerly FAS 141R), requires that in a business combination, an acquirer must record at fair value all assets, liability and any non-controlling interests in the acquiree. ASC 805 requires that intangible assets other than goodwill be recognized apart from goodwill if they meet certain criteria. ASC 805 further requires that goodwill be initially recognized as an asset in the financial statements, as the excess of

the cost of an acquired entity over the net of the amounts assigned to assets and liabilities assumed.

Once the underlying assets of an acquisition are recorded at their fair value, the rules as to whether or not to depreciate or amortize those assets and how and when to test for impairment writedown come into play.

The authority for testing impairment of long-lived assets, intangibles, and goodwill is found in a series of FASB statements that were issued in the early 2000s, and that drastically changed the way in which such assets were tested for impairment.

The following two tables summarize the authority for accounting for impairment of various assets:

Statement	Applies to
<i>Intangibles: Goodwill and Other</i> (ASC 350) (formerly FAS 142), as amended by ASU 2010-28 and ASU 2011-08	<ul style="list-style-type: none"> <li>■ Goodwill</li> <li>■ Intangible assets with indefinite lives</li> </ul>
<i>Impairments</i> (ASC 360) (formerly FAS 144)	<ul style="list-style-type: none"> <li>■ Long-lived assets (equipment, real estate, etc.)</li> <li>■ Intangible assets with finite lives</li> </ul>

**Accounting for Impairments of Assets**

Type of asset	Authority for impairment	Accounting treatment	Impairment test approval
<b>INTANGIBLE ASSETS:</b>			
Goodwill	ASC 350 (formerly FAS 142)	Not amortized	Tested annually for impairment
Intangibles with indefinite lives (trade names, etc.)	ASC 350 (formerly FAS 142)	Not amortized	Tested annually for impairment
Intangibles with finite lives (patents, agreements not to compete, etc.)	ASC 360 (formerly FAS 144)	Amortized	Tested for impairment only if there is an indication that an impairment might exist
<b>TANGIBLE ASSETS:</b>			
Long-lived tangible assets (equipment and real estate)	ASC 360 (formerly FAS 144)	Depreciated	Tested for impairment only if there is an indication that an impairment might exist

Because fair value is the basis for measuring impairment, ASC 820, Fair Value Measurement (formerly FAS 157) provides guidance by defining fair value and requiring an entity to follow ASC 820 anytime fair value is measured, such as in the case of ASC 350 (formerly FAS 142) and ASC 360 (formerly FAS 144).

In 2011 and 2012, the FASB issued two new accounting standards updates (ASUs) to offer an optional qualitative assessment of impairment:

- ASU 2011-08, *Intangibles—Goodwill and Other (Topic 350), Testing Goodwill for Impairment*, permits use of an optional qualitative assessment of goodwill impairment.

- ASU 2012-02, *Intangibles—Goodwill and Other (Topic 350) Testing Indefinite-Lived Intangible Assets for Impairment*, permits use of an optional qualitative assessment for intangible assets with indefinite lives.

Both of these qualitative assessments are the subject of this chapter.

## EXISTING GAAP FOR GOODWILL

Before reviewing the optional qualitative assessment available for goodwill, let's review the general rules related to recording goodwill and testing it for impairment.

ASC 805, *Business Combinations*, defines goodwill as:

... an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

ASC 350, *Intangibles: Goodwill and Other*, provides the rules for accounting for goodwill after a portion of the acquisition price is allocated to goodwill by ASC 805, *Business Combinations*.

### Rules for Testing Goodwill for Impairment Under ASC 350

Goodwill ***should not be amortized*** but should be tested for impairment *at least annually*. The test shall be performed at the *reporting unit level*.

A *reporting unit* is defined as an operating segment or one level below an operating segment.

#### NOTE

For most non-public entities, the entity has one reporting unit so that goodwill is tested at the entity level.

The annual impairment test may be performed any time during the fiscal year, provided the test is performed at the same time each year. Different reporting units may be tested for impairment at different times.

#### NOTE

Goodwill should be tested for impairment on an interim basis (between annual tests) if an event occurs or circumstances change that would make it more likely than not (more than 50 percent chance) that the fair value of the reporting unit would be below the carrying amount.

Factors that may require an entity to test for impairment on an interim basis (between annual tests) include the following:

- Macroeconomic conditions such as:
  - Deterioration in general economic conditions
  - Limitations on accessing capital
  - Fluctuations in foreign exchange rates
  - Other developments in equity and credit markets
- Industry and market considerations such as:
  - Deterioration in the environment in which an entity operates
  - Increased competitive environment
  - Decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers)
  - Change in the market for an entity's products or services, or a regulatory or political development
- Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows
- Overall financial performance such as:
  - Negative or declining cash flows
  - Decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods
- Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
- 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
  - Testing for recoverability of a significant asset group within a reporting unit
  - Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit
- If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers)
- Other relevant events and circumstances that affect the fair value or carrying amount in determining whether to perform the first step of the goodwill impairment test

Because goodwill is tested for impairment under ASC 350, *Intangibles: Goodwill and Other*, it should not be tested for impairment with other long-lived assets under ASC 360, *Property, Plant, and Equipment*.

If an asset group is tested for impairment under ASC 350, the ASC 360 impairment test of those assets shall be performed before the goodwill impairment test. Any impairment loss incurred on the test of the assets under ASC 360 should be recognized before the goodwill test is performed.

**EXAMPLE**

Reporting Unit X consists of various tangible and intangible assets, including goodwill. X is performing an impairment test of all of its assets under ASC 360. X also must perform its annual test for impairment of goodwill.

X should first perform its test for impairment of all of its tangible and intangible assets under ASC 360. If there is an impairment of those assets, they should be written down and an impairment loss recorded prior to including those assets in the test for impairment of goodwill under ASC 350. The written down assets would be used to test for goodwill impairment.

**Reporting Unit Versus Entity Level Assessment**

GAAP requires that goodwill be tested for impairment at the reporting unit level based on the assumption that many entities have several reporting units within one entity. A reporting unit is defined as an operating segment or one level below an operating segment.

As it relates to most closely held businesses, such entities typically have only one reporting unit, which is the entity as a whole. In such situations, goodwill is tested for impairment at the entity level (e.g., one reporting unit). For purposes of this chapter and the various examples that are included, the author assumes that the entity has one reporting unit. Thus, in all examples, goodwill is tested at the entity level.

**GAAP's Current Two-Step Test for Goodwill Impairment**

An entity is required to make an annual test of goodwill for impairment. The test is done separately for each reporting unit and may result in goodwill assigned to one unit being written down, while goodwill for another unit not being written down for impairment. Again, for most closely held businesses, there is only one reporting unit, which is the entity itself.

The standard test for impairment of goodwill consists of applying two formulas as follows:

- First Step: Identify a Potential Goodwill Impairment
- Second Step: Measure the Impairment

**First Step: Identify a Potential Goodwill Impairment**

A potential goodwill impairment exists if the fair value of the entity's stockholders' equity is less than the carrying amount of the entity's stockholders' equity using the following formula:

Fair value of the entity's stockholders' equity  
 Less: Carrying amount of entity's stockholders' equity  
 Equals: Negative amount — there is a potential impairment —  
 go to Second Step and measure the impairment

If fair value is *less than* the carrying amount of the entity's stockholders' equity, there is a potential impairment and the second step is performed. If fair value is *not less than* the carrying amount, there is no potential impairment and the second step is not performed.

**Second Step: Measure the Impairment Loss**

If fair value is less than the carrying amount of the entity's stockholders' equity, there is a potential impairment and the second step is performed as follows:

Fair value of the entity's stockholders' equity  
 Less: Fair value of entity's individual assets and liabilities (excluding goodwill)  
 Equals: Implied goodwill value  
 Less: Carrying amount of goodwill  
 Equals: Impairment loss

If the second step is not completed before the financial statements are issued and a goodwill impairment loss is probable and can be reasonably estimated, the best estimate of that loss should be recognized in those financial statements. Any adjustment to that estimated loss upon the completion of the loss measurement shall be recognized in the subsequent reporting period.

The aggregate amount of goodwill impairment losses must be presented as a separate line item in the income statement before the subtotal—income from continued operations (or a similar caption) unless a goodwill impairment loss is associated with a discontinued operation. A goodwill impairment loss associated with a discontinued operation must be included on a net-of-tax basis within the results of discontinued operations.

After the impairment loss is recognized, the adjusted carrying amount of goodwill becomes its new cost basis.

Once goodwill is written down, the writedown may not be restored. This fact emphasizes the importance of the timing of the impairment testing. For example, an entity may incur a goodwill writedown and loss due solely to the fact that the test is performed during a weak economic cycle when the entity's fair value is in decline. Subsequently, when the entity's fair value recovers, it is not able to restore the previously written down goodwill.

**EXAMPLE 1**

Company X is performing its annual test of goodwill impairment at December 31, 20XX.

**Facts:**

Fair value of Company X's stockholders' equity	\$1,000,000
Carrying amount of X's stockholders' equity	850,000
Fair value of X's individual assets and liabilities (exclusive of goodwill)	800,000
Carrying amount (book value) of goodwill	500,000

**First Step: Identify a Potential Impairment**

Fair value of X's stockholders' equity (SE)	\$1,000,000
Less: Carrying amount of SE	<u>850,000</u>
<b>Equals: Positive amount- no impairment</b>	<b><u>\$150,000</u></b>

**Conclusion:** Because the fair value of X's stockholders' equity exceeds its carrying amount, there is no impairment and the second step does not have to be performed.

**EXAMPLE 2**

Same facts as Example 1 except that the amounts have changed to the following:

Fair value of X's stockholders' equity	\$1,000,000
Carrying amount of X's stockholder's equity	1,100,000
Fair value of X's individual assets and liabilities (exclusive of goodwill)	800,000
Carrying amount (book value) of goodwill	500,000

**First Step: Identify a Potential Impairment:**

Fair value of X's SE	\$1,000,000
Less: Carrying amount of X's SE	<u>1,100,000</u>
<b>Equals: Negative amount- go to second step</b>	<b><u>\$(100,000)</u></b>

**Second Step: Measure the Impairment Loss:**

Fair value of X's SE	\$1,000,000
Less: Fair value of X's individual assets and liabilities (exclusive of goodwill)	<u>800,000</u>
Implied goodwill value	<u>\$200,000</u>
Less: Carrying amount of goodwill	<u>500,000</u>
<b>Equals: Impairment loss</b>	<b><u>\$(300,000)</u></b>

**Entry:**

Goodwill Impairment loss	300,000	
Goodwill		300,000

The impairment loss is presented on the statement of income in the following manner:

<b>Company X</b>	
<b>Statement of Income</b>	
<b>For the Year Ended December 31, 20XX</b>	
Net sales	\$xx
Cost of sales	xx
Gross profit	xx
Operating expenses	xx
<b>Impairment loss on goodwill</b>	<b><u>(300,000)</u></b>
Net income before income taxes	xx
Income taxes	xx
Net income	<b><u>\$xx</u></b>

**Is it possible to have an impairment in the first step yet have no writedown of goodwill in second step?** Yes. A company could have a negative amount in the first step. When the second step is performed, the implied goodwill value may be greater than the carrying amount of the goodwill. This result could be due to the fact that the company has goodwill with a low carrying amount. Example 2A illustrates this point.

**EXAMPLE 2A**

Same facts as Example 2 except that the amounts have changed to the following:

Fair value of X's stockholders' equity	\$1,000,000
Carrying amount of X's stockholder's equity	1,100,000
Fair value of X's individual assets and liabilities (exclusive of goodwill)	800,000
Carrying amount (book value) of goodwill	150,000

**First Step: Identify a Potential Impairment:**

Fair value of X's stockholders' equity	\$1,000,000
Less: Carrying amount of X's stockholders' equity	<u>1,100,000</u>
<b>Equals: Negative amount - go to second step</b>	<b><u>\$(100,000)</u></b>

**Second Step: Measure the Impairment Loss:**

Fair value of X's SE	\$1,000,000
Less: Fair value of X's individual assets and liabilities (exclusive of goodwill)	<u>800,000</u>
Implied goodwill value	\$200,000
Less: Carrying amount of goodwill	<u>150,000</u>
<b>Equals: Impairment loss</b>	<b><u>\$ 0</u></b>

**Entry:** NONE

In Example 2A, even though there is a potential impairment in the first step, when performing the second step, there is no impairment loss as implied goodwill of \$200,000 is greater than the \$150,000 carrying amount of goodwill.

### STUDY QUESTIONS

1. X is performing an impairment test of all of its assets including goodwill. Which of the following is the correct order in which X should test the impairment of its tangible and intangible assets other than goodwill, and its test of goodwill impairment?
  - a. Goodwill should be tested for impairment first and adjusted, and then the test for impairment of all other tangible and intangible assets should be done.
  - b. Goodwill and all other tangible and intangible assets should be combined and tested for impairment simultaneously under ASC 360.
  - c. All tangible and intangible assets other than goodwill should be tested and adjusted before the goodwill impairment test is performed.
  - d. Goodwill and all intangible assets should be tested together separate from the test of tangible assets.
  
2. Once goodwill is written down, the writedown \_\_\_\_\_.
  - a. May be written back up to the original cost
  - b. May be written back up without limit
  - c. May not be restored
  - d. May be restored only if there are certain factors that warrant a restoration
  
3. Which of the following is correct?
  - a. It is possible to have an impairment in the first step, yet have no writedown of goodwill in the second step.
  - b. If there is an impairment in the first step, there will automatically be a write-down of goodwill in the second step.
  - c. If there is an impairment in the first step, there will be no writedown of goodwill in the second step.
  - d. If there is an impairment in the first step, there could be a writeup of goodwill in the second step.

### GAAP CHANGE: OPTIONAL QUALITATIVE ASSESSMENT MADE BY ASU 2011-08

In September 2011, the FASB issued ASU 2011-08, *Intangibles—Goodwill and Other (Topic 350)*, Testing Goodwill for Impairment.

Prior to the issuance of ASU 2011-08, the only method available to perform the annual impairment test of goodwill was to use the two-step formula found in ASC 350. That test requires, at a minimum, that an entity perform the first step by comparing the fair value of the entity's stockholders' equity

to the carrying amount of its stockholders' equity. What this has meant is that in performing its annual test of goodwill, an entity has had to compute fair value (in step 1) which can be tedious, costly and time consuming. Companies complained to the FASB that they needed a simpler method by which to screen a company to determine whether there was a potential impairment of goodwill.

In response to requests by companies to simplify the annual test for goodwill impairment, in September 2011, the FASB issued another document, ASU 2011-08, *Intangibles—Goodwill and Other (Topic 350), Testing Goodwill for Impairment*, to allow (but not require) use of a qualitative assessment to test impairment of goodwill. This optional qualitative assessment, which is now in effect, may be performed prior to performing the first step in the two-step approach and may alleviate an entity having to perform either the first or second step.

### **Rules for the Qualitative Assessment Found in ASU 2011-08**

An entity has the option to first make a qualitative assessment to determine whether it is necessary to perform the two-step goodwill impairment test.

If, based on the qualitative assessment, it is not more likely than not (not more than 50 percent probability) that the fair value of the entity's stockholder's equity) is less than the carrying amount of its stockholders' equity, the entity may bypass the two-step test for impairment as there is no impairment.

If, based on the qualitative assessment, it is more likely than not (more than 50 percent probability) that the fair value of the entity's stockholders' equity is less than its carrying amount, the entity must perform the first step of the two-step impairment test and then, if necessary, perform the second step.

The optional qualitative assessment is mandatory for an entity that has a zero or negative carrying amount of stockholders' equity. (See rules below.)

#### **NOTE**

ASU 2011-08's qualitative assessment is an optional approach in lieu of the standard two-step quantitative test for impairment of goodwill. Because the qualitative assessment is optional, an entity has the choice not to perform the qualitative assessment and, instead, perform the two-step goodwill (quantitative) impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

In making the qualitative assessment, an entity may assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of the stockholders' equity is less than the carrying amount of stockholders' equity.

Examples of such qualitative factors (events and circumstances) include the following:

- Macroeconomic conditions such as:
  - Deterioration in general economic conditions
  - Limitations on accessing capital
  - Fluctuations in foreign exchange rates
  - Other developments in equity and credit markets
- Industry and market considerations such as:
  - Deterioration in the environment in which an entity operates
  - Increased competitive environment
  - Decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers)
  - Change in the market for an entity's products or services, or a regulatory or political development
- Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows
- Overall financial performance such as:
  - Negative or declining cash flows
  - Decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods
  - Several periods of net operating losses
- Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
- 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
  - Testing for recoverability of a significant asset group within a reporting unit
  - Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit
- If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers).
- Other relevant events and circumstances that affect the fair value or carrying amount in determining whether to perform the first step of the goodwill impairment test.

An entity shall consider the extent to which each of the qualitative factors (events and circumstances) could affect the comparison of an entity's fair value with its carrying amount considering the following guidelines:

- An entity should place more weight on the factors that most affect the entity's fair value or the carrying amount of its net assets. An entity should

consider positive and mitigating factors that may affect its determination of whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount.

- If an entity has a recent fair value calculation, it also should include as a factor in its consideration the difference between the fair value and the carrying amount in reaching its conclusion about whether to perform the first step of the goodwill impairment test.
- An entity shall evaluate, on the basis of the weight of evidence, the significance of all identified factors in the context of determining whether it is more likely than not that the fair value is less than its carrying amount.

#### NOTE

None of the individual examples of factors are intended to represent standalone events or circumstances that necessarily require an entity to perform the first step of the goodwill impairment test. The existence of positive and mitigating factors is not intended to represent a rebuttable presumption that an entity should not perform the first step of the goodwill impairment test.

## OTHER CHANGES MADE BY ASU 2011-08

### Carryforward Rule

ASU 2011-08 also eliminates use of the special goodwill impairment test carryforward rule that was included in the originally issued ASC 350. Under that rule, ASC 350 offered a special relief provision under which, if certain criteria were met, an entity was able to test for impairment in the first year and carryforward the test to each successive year without updating it. ASU 2011-08 amends ASC 350 to officially remove the special carryforward rule.

### Disclosures Clarification

ASU 2011-08 further provides a clarification with respect to disclosures involving goodwill impairment. It states that the quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy are not required for fair value measurements related to the financial accounting and reporting for goodwill after its initial recognition in a business combination.

### Qualitative Assessment for Carrying Amount of Zero or Negative

ASU 2011-08's qualitative assessment is *mandatory* for an entity that has a stockholders' equity carrying amount of *zero or negative*. The term "carrying amount" means the book value of an entity's total stockholders' equity. Thus, an entity with a carrying amount (book value) of its

total stockholders' equity of zero or negative *must* perform a qualitative assessment of goodwill. In such a situation, using the original two-step impairment test is not an option.

The first step in the two-step impairment test is bypassed in lieu of the qualitative assessment.

If, based on the qualitative assessment, it is not more likely than not (not more than 50 percent probability) that the fair value of the entity's stockholders' equity is *less than* its carrying amount, the entity may *bypass the two-step test* for impairment as there is no impairment.

If, based on the qualitative assessment, it is more likely than not (more than 50 percent probability) that the fair value of the entity's stockholders' equity is less than its carrying amount, there is an impairment and the entity must perform the second step of the two-step impairment test (Step 1 is not performed).

#### NOTE

In evaluating whether it is more likely than not that the goodwill of an entity with zero or negative stockholders' equity is impaired, an entity also should take into consideration whether there are significant differences between the carrying amount and the estimated fair value of its assets and liabilities, and the existence of significant unrecognized intangible assets.

#### OBSERVATION

The mandatory qualitative assessment rule for a carrying amount of zero or negative was created because companies were manipulating the previous rules for testing impairment of goodwill.

#### EXAMPLE 2

Company X has the following information. The entity is a single reporting unit so that goodwill is tested at the entity level.

Fair value of X's stockholders' equity	\$0
Carrying amount of X's stockholder's equity	(100,000,000)

Under the rules in effect prior to the required qualitative assessment, X would perform the first step as follows:

Fair value of X's stockholders' equity	\$0
Less: Carrying amount of X's stockholders' equity (deficit)	(100,000,000)

**NO IMPAIRMENT**

**POSITIVE**

Prior to the mandated use of the qualitative assessment for an entity with a zero or negative carrying amount of stockholders' equity, in the above

example, Company X would avoid having to record an impairment loss because the fair value of X's stockholders' equity (zero) was greater than its negative carrying amount (\$(100 million)). Yet, with such a large negative carrying amount, it is likely that the company would have an impairment if the second step was performed. Note further that because fair value can never be less than zero, fair value always exceeds a negative carrying amount so that an entity with a negative carrying amount (deficit stockholders' equity) would never have an impairment in the first step and would not measure an impairment in the second step.

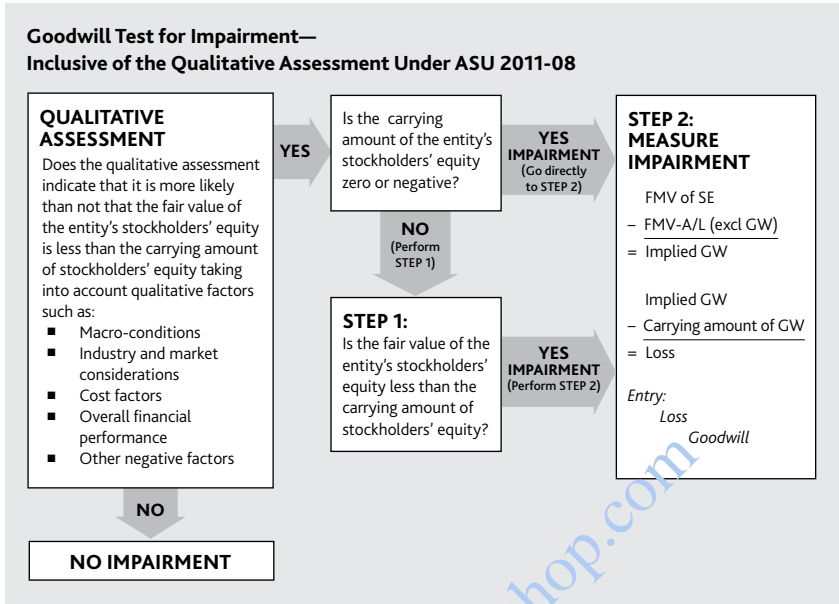
ASU 2011-08 resolved this situation by requiring an entity with either a zero or negative stockholders' equity to perform a qualitative assessment (look at qualitative factors) in lieu of performing the first step of the impairment test. If, after performing the qualitative assessment, it is more likely than not (more than 50 percent likelihood) that a goodwill impairment exists (fair value of stockholders' equity is *less than* its carrying amount), then the entity goes directly to the second step to measure the impairment. The first step is bypassed.

Without the issuance of ASU 2011-08, companies with significant amounts of goodwill and deficits in stockholders' equity were able to avoid writedowns of goodwill under the impairment rules. Now that loophole has been closed with ASU 2011-08.

## TRANSITION

Use of the qualitative assessment found in Accounting Standards Update No. 2011-08, *Intangibles— Goodwill and Other (Topic 350): Testing Goodwill for Impairment* shall be applied prospectively for annual and interim goodwill impairment tests performed for fiscal years *beginning after December 15, 2011*. Earlier application is permitted.

Earlier application also is permitted for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if the entity's financial statements for the most recent annual or interim period have not yet been issued or, for non-public entities, have not yet been made available for issuance.



**EXAMPLES ILLUSTRATING THE APPLICATION OF THE QUALITATIVE ASSESSMENT OF ASU 2011-08**

**Example 1: Qualitative Assessment**

Company X is performing its annual test of goodwill impairment at December 31, 20XX. Company X has one reporting unit so that goodwill is tested at the entity level. X has goodwill with a carrying amount of \$500,000. X does not want to waste time testing goodwill using the two-step approach, which requires that X measure fair value.

X chooses to perform a qualitative assessment of whether there may be an impairment. In making the assessment, X should evaluate various qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of X's stockholders' equity is less than its carrying amount.

Following is a chart in which X evaluates certain qualitative factors:

Qualitative factor	Does it exist in Company X?
Macroeconomic conditions such as deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets?	No
Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider 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?	No

Qualitative factor	Does it exist in Company X?
Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows?	Some increases in raw materials costs that do not have a significant negative effect on earnings and cash flow
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?	No. Company is profitable although sales are flat, but not declining.
Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation?	No
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?	No
If applicable, is there a sustained decrease in share price (consider in both absolute terms and relative to peers)?	Not applicable. X is a closely held company that does not trade shares of its stock.
Other relevant events and circumstances that affect the fair value or carrying amount in determining whether to perform the first step of the goodwill impairment test?	Nothing significant

**Conclusion:** Although the list of qualitative factors may not be all-inclusive, when considered in its entirety, the results of the assessment indicate that it is not more likely than not (not more than 50 percent probability) that the fair value of X’s stockholders’ equity is less than the carrying amount of X’s stockholders’ equity.

Therefore, there is no impairment of X’s goodwill and the two-step impairment test does not have to be performed. The best news is that by using the qualitative assessment, X does not have to deal with the two-step fair value test which is based on measuring fair value.

**Example 2: Qualitative Assessment**

Same facts as Example 1, but the qualitative assessment encompasses the following information.

Qualitative factor	Does it exist in Company X?
Macroeconomic conditions such as deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets?	Yes. X is having trouble refinancing its existing debt due to recurring losses and insufficient equity.
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 (consider 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?	Yes. Competition from China and South America has resulted in a deterioration of sales over the past two years and a reduction in backlog of sales going forward.

Qualitative factor	Does it exist in Company X?
Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows?	Yes. There have been steady increases in raw materials costs and the inability to pass along the additional cost by increasing sales prices.
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?	Yes. The company has had several years of recurring losses that has resulted in tight cash flow.
Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation?	No
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?	No
If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers)?	Not applicable. X is a closely held company that does not trade shares of its stock.
Other relevant events and circumstances that affect the fair value or carrying amount in determining whether to perform the first step of the goodwill impairment test?	Nothing significant

**Conclusion:** Although not all of the qualitative factors in Example 2 are negative, there are enough of them that suggest that it is more likely than not (more than 50 percent probability) that the fair value of X’s stockholders’ equity is less than its carrying amount. Therefore, X should perform the two-step test for goodwill impairment. That means that X now has to deal with measuring fair value of X in the first step of the two-step test, and possibly the second step, if applicable.

Assume the following additional information is used in performing the two-step goodwill impairment test:

Fair value of X’s stockholders’ equity	\$1,000,000
Carrying amount of X’s stockholders’ equity	1,100,000
Fair value of individual assets and liabilities of X (exclusive of goodwill)	800,000
Carrying amount (book value) of goodwill	500,000
<b>First Step: Identify a Potential Impairment:</b>	
Fair value of X’s stockholders’ equity	\$1,000,000
Less: Carrying amount of X’s stockholders’ equity	<u>1,100,000</u>
<b>Equals: Negative amount</b>	<b><u>\$(100,000)</u></b>
<b>POTENTIAL IMPAIRMENT—go to second step</b>	

<b>Second Step: Measure the Impairment Loss:</b>		
Fair value of X's stockholder's equity	\$1,000,000	
Less: Fair value of individual assets and liabilities of X (exclusive of goodwill)	<u>800,000</u>	
Implied goodwill value		\$200,000
Less: Carrying amount of goodwill		<u>500,000</u>
<b>Equals: Impairment loss</b>		<b><u>\$(300,000)</u></b>
<b>Entry:</b>		
Goodwill Impairment loss	300,000	
Goodwill		300,000

**OBSERVATION**

By introducing an optional qualitative assessment as a precursor to performing the two-step goodwill impairment test, many otherwise profitable companies can avoid having to deal with the laborious task of measuring fair value as required in the first step of the impairment test and, if necessary, the second step. Previously, many companies wasted time and cost by performing the first step (comparing fair value to carrying amount) only to conclude that the fair value far exceeded the carrying amount resulting in no impairment and no need to perform the second step.

Of course, whenever qualitative information is introduced into GAAP, there is the potential for abuse. After all, it would not be difficult for an entity to manipulate the qualitative information to reach whichever conclusion it desires particularly when some, but not all, of the qualitative factors point in a negative direction.

**Example 3: Qualitative Assessment—Carrying Amount is Zero or Negative**

Company X is performing its annual test of goodwill impairment at December 31, 20XX. X has one reporting unit so that the test is performed at the entity level:

Fair value of X's stockholders' equity	\$1,200,000
Carrying amount of X's stockholders' equity	(700,000)
Fair value of X's individual assets and liabilities (exclusive of goodwill)	900,000
Carrying amount (book value) of goodwill	300,000

During the year, Company X incurred several adverse qualitative factors as follows:

- X is limited to access to additional financing due to the general economic conditions.
- X was sued by a competitor for patent infringement involving X's key product.
- X lost its top salesperson resulting in a significant reduction in sales.

- A new competitor has entered the market with sizeable resources.
- X has had several years of significant net losses and declining cash flows.

**Conclusion:** ASU 2011-08 states that if an entity has a carrying amount of its stockholders equity of zero or negative, the entity *must perform the qualitative assessment* of goodwill impairment. If, after performing the qualitative assessment, it is more likely than not (more than 50 percent likelihood) that the fair value of the entity’s stockholders’ equity is less than its carrying amount, then there is a potential impairment and the entity *should go directly to the second step* and measure the impairment.

In this example, the carrying amount is less than zero (\$700,000). Further, the adverse qualitative factors listed above support the fact that it is more likely than not that a goodwill impairment exists. Therefore, there is a potential impairment and the second step should be performed to measure a goodwill impairment as follows:

<b>Second Step: Measure the Impairment Loss:</b>	
Fair value of X’s stockholders’ equity	\$1,000,000
Less: Fair value of X’s individual assets and liabilities (exclusive of goodwill)	<u>900,000</u>
Implied goodwill value	\$100,000
Less: Carrying amount of goodwill	<u>300,000</u>
<b>Equals: Impairment loss</b>	<b><u>\$(200,000)</u></b>
<b>Entry:</b>	
Goodwill Impairment loss	200,000
Goodwill	200,000

**Example 3A: Carrying Amount is Zero or Negative**

Company X is performing its annual test of goodwill impairment at December 31, 20XX.

Fair value of X’s stockholders’ equity	\$1,200,000
Carrying amount of X’s stockholders’ equity	(700,000)
Fair value of X’s individual assets and liabilities (exclusive of goodwill)	900,000
Carrying amount (book value) of goodwill	300,000

During the year, Company X had *no significant adverse qualitative factors*.

**Conclusion:** ASU 2011-08 states that if an entity has a carrying amount of its stockholders’ equity is zero or negative, a qualitative assessment of goodwill impairment is required.

If, based on the qualitative assessment, it is not more likely than not (not more than 50 percent probability) that the fair value of the entity's stockholders' equity is *less than* its carrying amount, the entity may *bypass the two-step test* for impairment as there is no impairment.

In this example, the carrying amount is less than zero (\$700,000) so that a qualitative assessment is required.

Based on the assessment, there are no significant adverse qualitative factors that would indicate that it is more likely than not that the fair value of X is less than X's carrying amount. Thus, there is no potential impairment and there should be no test for impairment.

## STUDY QUESTIONS

4. An entity is performing a qualitative assessment of impairment of its goodwill. The entity concludes that it is more likely than not that the fair value of the entity's stockholders' equity is not less than its carrying amount. Which of the following is correct?
  - a. The entity must perform the first step of the two-step impairment test.
  - b. The entity may bypass the first step and go directly to the second step.
  - c. The entity may bypass the two-step test for impairment.
  - d. The entity must perform both steps of the two-step impairment test.
  
5. Which of the following is a change made to the goodwill impairment rules by ASU 2011-08?
  - a. The ASU eliminates use of the special goodwill impairment test carryforward rule.
  - b. The ASU adds a new special goodwill impairment test carryforward rule.
  - c. The ASU does not affect the special goodwill impairment test carryforward rule.
  - d. The ASU adds a new safe harbor rule for goodwill impairment.
  
6. In making the qualitative assessment, a qualitative factor to consider includes which of the following?
  - a. Stable foreign exchange rates
  - b. Abundance of capital
  - c. A change in key personnel
  - d. A decrease in the competitive environment

## CHANGES MADE TO IMPAIRMENT OF INTANGIBLE ASSETS WITH INDEFINITE LIVES

### Background

In July 2012, the FASB issued Accounting Standards Update (ASU) 2012-02 entitled, Intangibles—Goodwill and Other (Topic 350) Testing Indefinite-Lived Intangible Assets for Impairment. The overall objective of the ASU is

to permit (but not require) that an optional qualitative assessment of impairment be permitted for intangible assets with indefinite lives, similar to the qualitative assessment permitted for goodwill by ASU 2011-08.

Going back to the chart previously discussed in this chapter, intangible assets and goodwill are segregated into four categories under GAAP as follows:

### Accounting for Impairments of Assets

Type of asset	Authority for impairment	Accounting treatment	Impairment test approval
Goodwill	ASC 350 (formerly FAS 142)	Not amortized	Tested annually for impairment
Intangibles with indefinite lives (trade names, etc.)	ASC 350 (formerly FAS 142)	Not amortized	Tested annually for impairment
Long-lived tangible assets (equipment and real estate)	ASC 360 (formerly FAS 144)	Depreciated	Tested for impairment only if there is an indication that an impairment might exist
Intangibles with finite lives (patents, etc.)	ASC 360 (formerly FAS 144)	Amortized	Tested for impairment only if there is an indication that an impairment might exist

An intangible asset with an indefinite life *should not be amortized* until its life is determined to be no longer indefinite. An intangible asset is deemed to have an indefinite life if there is no legal, regulatory, contractual, competitive, economic, or other factor that limit the useful life of an intangible asset. That is, there is no limit placed on the end of the asset's useful life to the reporting entity.

Examples of intangible assets that might have indefinite lives include:

- Certain trademarks and tradenames
- Certain licenses such as liquor and broadcast licenses
- Taxi medallions
- Franchises
- Airport routes

A company is required to follow certain rules in ASC 350 in testing an intangible with an indefinite life for impairment. Unlike goodwill, the impairment test for an intangible asset with an indefinite life consists of a single step as follows:

Formula for Annual Impairment Test- Indefinite-lived intangible:

$$\begin{array}{l} \text{Fair value of intangible asset} \\ \text{Less: Carrying amount of intangible asset} \\ \hline \text{Equals: Impairment loss} \end{array}$$

If an impairment loss is recognized, the written-down carrying amount of the intangible shall be the asset's new basis for subsequent impairment tests. The reversal of previously recognized impairment losses is prohibited.

**EXAMPLE**

In 20X1, Joe’s Manhattan Taxi Service purchases a competitor’s business that includes 30 taxi licenses (medallions). Out of the total purchase price of \$10 million, \$7 million is assigned to the 30 taxi licenses based on the fair value in the marketplace. The licenses have an indefinite life and are renewed annually by paying a small renewal fee.

**Conclusion:** The \$7 million of cost allocated to the intangible asset (licenses) should not be amortized until the useful economic life becomes finite. However, each year the Company should test the licenses for impairment by comparing the \$7 million carrying amount to the fair value in the market.

Assume that on December 31, 20X1, the fair value of the licenses is \$5 million. The licenses should be written down to fair value as follows:

Fair value of licenses	\$5,000,000
Less: Carrying amount of licenses	7,000,000
<b>Equals: Impairment loss</b>	<b>\$(2,000,000)</b>

Entry: December 31, 20X1:

Loss	2,000,000	
Licenses		2,000,000

**Change the facts:** Assume on January 1, 20X2, the local government changes the law and states that all licenses will become null and void at the end of 20X8.

**Conclusion:** At this point, the useful economic life is now finite, with seven years remaining. The revised carrying amount of \$5 million should be amortized over the seven-year period (20X2 through 20X8) on a straight-line basis, unless another systematic and rational method is used.

**Changes Made by ASU 2012-02**

ASU 2012-02 makes the following changes to the impairment test rules for intangible assets with indefinite lives.

An intangible asset (other than goodwill) that is not subject to amortization (indefinite-lived) shall be tested for impairment annually, and more frequently if events or changes in circumstances indicate that the asset might be impaired.

For an intangible asset that is not subject to amortization for impairment, an entity may first perform a qualitative assessment to determine whether it is necessary to calculate the fair value of an indefinite-lived intangible asset.

An entity has an unconditional option to bypass that qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test (e.g., compare fair value to carrying amount).

An entity may resume performing the qualitative assessment in any subsequent period.

### Performing the Qualitative Assessment

If an entity elects to perform a qualitative assessment, it shall first assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that an indefinite-lived intangible asset is impaired.

An entity shall assess all relevant events and circumstances that may affect the significant inputs used in determining the fair value of the indefinite-lived intangible asset. In conducting this qualitative assessment, an entity should consider the examples of events and circumstances included in the following list, which is not all inclusive:

- Macroeconomic conditions such as deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets
- 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 (consider 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
- Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows
- 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
- Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
- Legal, regulatory, contractual, political, business, or other factors, including asset-specific factors that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset.

An entity shall consider the extent to which each of the adverse events and circumstances identified could affect the fair value of an indefinite-lived intangible asset.

#### NOTE

An entity also should consider positive and mitigating events and circumstances that may affect its determination of whether it is more likely than not that the indefinite-lived intangible asset is impaired. If an entity has made a recent fair value calculation for an indefinite-lived intangible asset, it also should include as a factor in its consideration the difference between that fair value and the current carrying amount in reaching its conclusion about whether it is more likely than not that the indefinite-lived intangible asset is impaired. An entity also shall consider whether there have been any changes to the carrying amount of the indefinite-lived intangible asset in determining whether it is more likely than not that the intangible asset is impaired.

An entity shall evaluate, on the basis of the weight of the evidence, the significance of all identified events and circumstances in the context of determining whether it is more likely than not that the indefinite-lived intangible asset is impaired.

#### NOTE

None of the individual examples of events and circumstances are intended to represent standalone events or circumstances that necessarily require an entity to calculate the fair value of an intangible asset. Also, the existence of positive and mitigating events and circumstances is not intended to represent a rebuttable presumption that an entity should not calculate the fair value of an indefinite-lived intangible asset.

If, after assessing the totality of events and circumstances and their potential effect on significant inputs to the fair value determination, an entity determines that it is *not* more likely than not that the indefinite-lived intangible asset is impaired, then calculating the fair value of the asset and performing the impairment test is unnecessary.

If, after assessing the totality of events and circumstances and their potential effect on significant inputs to the fair value determination, an entity determines that it is more likely than not that the indefinite-lived intangible asset is impaired, then the entity shall calculate the fair value of the intangible asset and perform the impairment test.

Formula for Annual Impairment Test- Indefinite-lived intangible:

Fair value of intangible asset  
 Less: Carrying amount of intangible asset  
 Equals: Impairment loss

The impairment test for an indefinite-lived intangible asset shall consist of a comparison of the fair value of the asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, the entity shall recognize an impairment loss in an amount equal to that excess.

After the impairment loss is recognized, the adjusted carrying amount of the intangible asset shall be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

#### Effective Date

The amendments made by ASU 2012-02 are effective for annual and interim impairment tests performed for fiscal years *beginning after September 15, 2012*. Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012.

**STUDY QUESTION**

7. Under the qualitative assessment for impairment of an indefinite-lived intangible asset, if, after performing the qualitative assessment, it is more likely than not that the asset is impaired, which of the following occurs?
- There is no impairment test because it is unnecessary.
  - The entity shall calculate the fair value of the intangible asset and perform the impairment test.
  - The entity shall perform the two-step quantitative impairment test similar to the one performed for goodwill.
  - Additional qualitative procedures are performed.

**DEFERRED INCOME TAXES—IMPAIRMENTS**

When there is an impairment of goodwill or an intangible asset with an indefinite life, the result is that the asset is written down for book purposes, but not for tax purposes. The impairment loss represents a temporary difference that leads to the recording of a deferred income tax asset.

Assume that on December 31, 20X10, there is an impairment writedown of goodwill in the amount of \$100,000 for book purposes. The deferred tax asset would be computed as follows:

<b>At December 31, 20X10:</b>		
Goodwill book basis		\$450,000
20X10 impairment writedown		<u>(100,000)</u>
Revised book basis		350,000
Tax basis		<u>150,000</u>
Revised temporary difference		<u>(200,000)</u>
Temporary difference before writedown		(300,000)
Reversal of temporary difference		100,000
Tax rate		40%
DIT provision adjustment- 20X10		<u>\$40,000</u>
<b>Entry: 20X10</b>		
Impairment loss	100,000	
Goodwill		100,000
Deferred income tax asset	40,000	
Income tax expense- deferred		40,000

The deferred tax asset reverses through future depreciation or through the ultimate sale of the asset.

**Are Deferred Tax Assets and Liabilities Included as Recognized Assets or Liabilities in Testing for Goodwill of a Reporting Unit?**

Yes. All assets and liabilities assigned to a unit are included for purposes of the test. Assume that a test for impairment is being done for a reporting unit. The deferred tax assets are included in the value of the recognized assets of the unit such as in the case of the example that follows:

Fair value of recognized assets:	
	<b>Reporting Unit A</b>
Assets excluding goodwill	\$400
Total assets	900
Liabilities:	
Accounts payable	(100)
Accrued expenses	(150)
<b>Deferred income taxes</b>	<b><u>(200)</u></b>
Net assets	<u>\$850</u>

Assume that the fair value of Unit A is \$1,000. The implied value of goodwill would be as follows:

Fair value of Unit A	\$1,000
Fair value of recognized assets and liabilities (excluding goodwill)*	<u>850</u>
Implied goodwill	150
Carrying amount of goodwill	<u>80</u>
Impairment loss	<u>\$70</u>
* Includes deferred tax liability.	

In the above example, the deferred tax liability of \$200 is included in the net assets of Unit A in computing the impairment loss on goodwill.

**FINANCIAL STATEMENT DISPLAY OF IMPAIRMENTS**

ASC 350 provides that all impairment losses should be presented in the financial statements as part of income from continuing operations or a similar caption:

- Impairment losses related to goodwill should be aggregated and presented as a separate line item from impairment losses related to indefinite-lived intangibles.
- Impairment losses associated with a discontinued operation should be included (on a net-of-tax basis) within the results of discontinued operations.

For a not-for-profit organization, the loss is presented in income from continuing operations in the statement of activities.

**Illustration of Financial Statement Presentation:**

Net sales	\$xx
Cost of sales	<u>xx</u>
Gross profit on sales	xx
Selling, general, and administrative expenses	xx
<b><i>Impairment losses related to indefinite-lived intangible assets</i></b>	xx
<b><i>Goodwill impairment losses</i></b>	<u>xx</u>
Income from operations	xx
Other income (expense)	<u>xx</u>
Income before income taxes	xx
Income tax expense	<u>xx</u>
Net income	<u>\$xx</u>

**How Should Impairment Losses be Presented in the Statement of Cash Flows?**

An impairment loss related to goodwill or an indefinite-lived intangible asset is a non-cash item that should be shown as an adjustment (addback) in the operating section of the statement of cash flows:

**EXAMPLE**

Assume an impairment loss of \$100,000 on goodwill.

Net income	\$XX
Adjustments to reconcile net income to cash from operating activities:	
Depreciation and amortization	XX
Deferred income taxes	XX
<b><i>Goodwill impairment loss</i></b>	<b>100,000</b>
Increase in accounts receivable	XX
Decrease in inventories	XX
Increase in accounts payable	XX
Increase in accrued expenses	<u>XX</u>
Net cash from operating activities	<u>\$XX</u>

**DISCLOSURES OF IMPAIRMENTS**

ASC 350 requires the following disclosures for impairment losses involving goodwill and intangible assets with indefinite lives:

- Goodwill: The aggregate amount of impairment losses recognized
- Goodwill impairment losses: For each goodwill impairment loss recognized, the following shall be disclosed in the notes that include the period in which the impairment loss is recognized:

- A description of the facts and circumstances leading to the impairment
- The amount of the impairment loss and the method of determining the fair value of the associated reporting unit (whether based on quoted market prices, prices of comparable businesses, a present value or other valuation technique, or a combination thereof)
- If a recognized impairment loss is an estimate that has not yet been finalized, that fact and the reasons thereof and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss

**EXAMPLE 1: Footnote and Presentation**

Consistent with the broad philosophical direction of the Risk Assessment Standards, At December 31, 20X2, Company A's financial statements look like this:

**Company A  
Balance Sheet  
December 31, 20X2 (\$000s)**

<u>Current assets:</u>		<u>Current liabilities:</u>	
Cash	\$xx	Accounts payable	\$xx
Accounts receivable	xx	Accrued expenses	xx
Inventory	xx	Current portion of debt	xx
Other current assets	xx	Other current liabilities	xx
Total current assets	<u>2xx</u>	Total current liabilities	<u>xx</u>
Property, plant and equipment, net	xx	Long-term debt	<u>xx</u>
Goodwill	xx	Stockholder's equity	<u>xx</u>
Other intangibles assets, net	<u>xx</u>		
Total assets	<u>\$xx</u>	Total liabilities and equity	<u>\$xx</u>

**Company A  
Statement of Income  
For the Year Ended December 31, 20X2**

Sales	\$xx
Cost of sales	<u>xx</u>
Gross profit on sales	xx
Selling, general and administrative expenses	xx
<b>Impairment losses related to indefinite lived intangible assets</b>	<b>(1,000)</b>
<b>Goodwill impairment losses</b>	<b>(2,000)</b>
Income from operations	xx
Income tax expense	<u>xx</u>
Income before discontinued operations	xx
Discontinued operations (net of \$xx tax benefit)	xx
Extraordinary items (net of \$xx tax benefit)	<u>xx</u>
Net income	<u>\$xx</u>

The following disclosures are required by ASC 350.

Disclosures in 20X2:

**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

***Impairment losses:***

***Impairment losses related to goodwill and intangible assets with indefinite lives are recorded in the statement of income as part of income from operations.***

**NOTE X: IMPAIRMENT LOSSES:**

***In 20X2, the Company recorded an impairment loss in the amount of \$2,000 related to the writedown of goodwill associated with its web broadcasting unit.*** The unit's primary revenue is derived from offering video and audio streaming services to businesses throughout the United States and European markets. The broadcasting unit has incurred three consecutive years of operating losses as a result of increased competition and a lag in anticipated cost efficiencies from new technologies. The fair value of the web broadcasting unit was estimated using the expected present value of future cash flows. The \$2,000 impairment loss is presented as a separate line item in the statement of income as part of income from operations.

In addition, the Company recorded an impairment loss of \$1,000 related to the writedown to fair value of certain web broadcast trademarks of its streaming business.

*(Publicly held companies only)*

The impairment loss is included in the Widget Manufacturing segment which is more fully disclosed in Note 10.

## **AVOIDING IMPAIRMENT LOSSES UNDER GAAP**

There are three ways to avoid having to record impairment losses under GAAP:

1. Use OCBOA- income tax basis accrual financial statements
2. Ignore ASC 350 based on the argument that its effect is not material
3. Ignore ASC 350 and reference a GAAP departure exception in the report

### **Use OCBOA - Income Tax Basis Accrual Financial Statements**

One way to avoid having to deal with ASC 350 issues is to use OCBOA-income tax basis financial statements. By doing so, goodwill and intangibles are amortized over 15 years under Section 197 of the Internal Revenue Code, thereby avoiding the test of impairment altogether. If OCBOA financial statements are used, those GAAP disclosures that are applicable to OCBOA

financial statements must still be made. Interpretation 14 of Statement of Auditing Standards (SAS) 62 requires that if OCBOA financial statements are issued, all relevant disclosures that are similar to those required by GAAP must be made.

### **Ignore ASC 350 Based on the Argument that its Effect is Not Material**

A second way to avoid ASC 350 is to not implement it at all based on the argument that avoidance has an immaterial impact on the financial statements. There are numerous small businesses that have an immaterial, even de minimis amount of goodwill and intangible assets on their balance sheets. Are such companies required to implement ASC 350 when the result would not be material?

#### **OBSERVATION**

The author believes that if a company has an immaterial amount of goodwill on its balance sheet that is has been amortizing, the company could continue to amortize these assets despite the fact that it violates ASC 350. This argument is supported by the fact that if the company continues to amortize goodwill, the result is not material. That is, the small amount of amortization and the undersized goodwill are not material as a percentage of net income and total assets, respectively. The author does recommend that the accountant's or auditor's working papers include an explanation that he or she is aware of the fact that ASC 350 should be adopted, but that the effect of its adoption and continued application would be immaterial to the financial statements.

### **Ignore ASC 350 and Reference a GAAP Departure Exception in the Report**

A third option is for the company to simply violate GAAP by ignoring ASC 350. If the impact of continuing to amortize goodwill is material, there is a GAAP departure which requires an exception in the accountant's or auditor's report.

## Examples

### Accountant's Compilation Report

Board of Directors  
XYZ Company

We have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements. ***During our compilation, we did become aware of a departure from accounting principles generally accepted in the United States of America that is (are) described in the following paragraph.***

***Accounting principles generally accepted in the United States of America require that goodwill not be amortized and be tested annually for impairment. Management has informed us that the company continues to amortize goodwill and has not conducted the annual impairment test. The effects of these departures from accounting principles generally accepted in the United States of America have not been determined. [Or, The effects of these departures would have been to increase goodwill by \$xx and xx, respectively, retained earnings by \$xx, and net income by \$xx.]***

James J. Fox & Company  
Burlington, Massachusetts

Date:

### Independent Accountant's Review Report

Board of Directors  
XYZ Company

We have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management is responsible for the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

Based on our review, **with the exception of the matter described in the following paragraph**, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

***As disclosed in Note X to the financial statements, accounting principles generally accepted in the United States of America require that goodwill not be amortized and be tested annually for impairment. Management has informed us that the Company continues to amortize goodwill and has not conducted the annual impairment test. The effects of these departures from accounting principles generally accepted in the United States of America have not been determined. [Or, the effects of these departures would have been to increase goodwill by \$xx and xx, respectively, retained earnings by \$xx, and net income by \$xx.]***

James J. Fox & Company  
Burlington, Massachusetts

Date:

## Independent Auditor's Report

Board of Directors  
XYZ Company  
Nowhere, Massachusetts

We have audited the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, and the related notes to the financial statements.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

### **Basis for Qualified Opinion**

*As disclosed in Note X, in connection with goodwill, the company has recorded amortization expense and has not tested these assets for impairment. In our opinion, goodwill should not be amortized and should be tested annually for impairment in accordance with accounting principles generally accepted in the United States of America. The effects of these departures from accounting principles generally accepted in the United States of America have not been determined. [If the financial statements were corrected for that departure from accounting principles generally accepted in the United States of America, goodwill would have increased by \$xx and net income and retained earnings would have increased by \$xx.]*

**Qualified Opinion**

In our opinion, **except for the effects of the matters described in the Basis for Qualified Opinion paragraph**, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

James J. Fox & Company  
Burlington, Massachusetts

Date:

**STUDY QUESTIONS**

8. Company X has an impairment writedown of goodwill and intangibles with indefinite lives in the amount of \$200,000. X's federal and state tax rate is 40 percent. Which of the following is the correct deferred income tax result?
- X should record a deferred income tax liability in the amount of \$80,000.
  - X should record a deferred income tax asset in the amount of \$80,000.
  - X should not record any deferred income tax related to this transaction because the writedown will also be recorded on the tax return.
  - X should record both a deferred income tax asset and liability in the amount of \$80,000 each.
9. If there is an impairment loss, the loss should be presented \_\_\_\_\_.
- In the income statement before the subtotal income from continued operations
  - In the statement of comprehensive income as an element of other comprehensive income, net of the tax effect
  - In the income statement as a separate line item, net of the tax effect
  - In the income statement, in the other income section

## Fair Value Measurements

### LEARNING OBJECTIVES

Upon completion of this chapter, the reader will be able to:

- Identify the objectives of GAAP's fair value measurement framework
- Explain the concept of fair value and cite associated definitions
- List major categories of valuation approaches and related inputs
- Explain the hierarchy of inputs to fair value measurements
- Identify the basic disclosures required by ASC 820

### THE FRAMEWORK

This chapter introduces you to the framework set out in generally accepted accounting principles (GAAP) for measuring an item at its fair value. That framework is set out in FASB Accounting Standards Codification® Topic 820, *Fair Value Measurements*.

The fair value measurement framework:

- Sets out the concept of fair value
- Discusses valuation approaches (and related inputs) on which fair value measurement may be based
- Prioritizes inputs (and, by that, measurements) into a hierarchy based on their relative strength

Like GAAP, this chapter distinguishes between valuation and measurement. Valuation—the act of making judgments about the value of an item—is an activity broader than financial reporting. Measurement—the act of assigning a single value to an item for financial reporting purposes—involves valuation but ultimately requires the selection of a single amount to be recognized.

There are various bases used for measurement under generally accepted accounting principles. Over the last 20 years, fair value measurements have increased—especially for financial instruments, derivative instruments, and various disclosures). But, although fair value has often been painted as one side of a dichotomy between historic prices and current prices (or “historical cost versus fair value”), the reality is more complex. Two examples follow.

- The initial measurement and subsequent measurement of items under generally accepted accounting principles are not consistently based on any one measurement attribute. Some initial recognition is based on the

price of the transaction whether or not that price fits the concept of fair value under the framework discussed in this chapter. For example, an entity that issues certain guarantees measures its liability initially as the premium received rather than at fair value. (460-10-30-2(a)) Similarly, subsequent measurement often adjusts previously recorded amounts for some aspect of market conditions current at the measurement date.

- A subsequent measurement that uses current prices doesn't necessarily involve a one-to-one correspondence between the current price of the actual item being measured and what is reported. That may be because the unit of account recognized under GAAP and the unit of account for which current prices are available may be different. For example, measurement of a collateral-dependent receivable may report the receivable at the fair value of the collateral. (310-10-35-22)

The fair value measurement framework set out in GAAP as FASB Accounting Standards Codification® Topic 820, *Fair Value Measurements*, doesn't say *when* to measure at fair value but how to measure fair value if GAAP other than Topic 820 requires (or permits) a fair value measurement:

- Upon initial recognition of the item (initial measurement)
- After initial recognition (subsequent measurement)
- For disclosure purposes (disclosure)

Included are fair value measurements that are part of the disclosure basis or another basis of measurement. For example, measurement of certain receivables under generally accepted accounting principles considers fair value less costs to sell; the required *fair value* measurement that is part of "*fair value less costs to sell*" is subject to the framework.

#### **OBSERVATION**

Before applying the fair value measurement framework to an item, it is important to confirm both that the objective in applicable GAAP is actually fair value *and* that Topic 820 applies.

Some measurements used in revenue recognition involving software and multiple-element arrangements may seem similar to, but are not, fair value measurements and, so, are not subject to the Topic 820 framework. (820-10-15-2)

Further, there are various circumstances in which GAAP gives an "out" to fair value measurement of an item under different rationales. For example, GAAP allows the transaction price (rather than fair value) to be used to initially recognize certain guarantees. (460-10-30-2(a)) The fair value measurement framework doesn't apply in those circumstances. (For a list of the exceptions, see 820-10-15-3.)

Finally, Topic 820 doesn't actually apply pervasively or consistently to all fair value measurements required and permitted by GAAP. Specifically, the fair value measurement framework in Topic 820 doesn't apply to fair value measurements involving a lease (other than in a business combination) or a share-based payment transaction. (820-10-15-2) Rather GAAP for those items provides another "fair value" definition and accompanying guidance on fair value measurements of those items.

Topic 820 reflects efforts between the Financial Accounting Standards Board and the International Accounting Standards Board (IASB) to conform fair value measurement guidance under U.S. GAAP and International Financial Reporting Standards (IFRSs). In addition to nonsubstantive editorial differences, several differences remain involving:

- Accounting by an investment company
- Fair value measurement of a demand deposit by a depository institution
- Interaction of fair value measurement with other disclosure and presentation guidance (for example, the implications when netting is permitted by other guidance)
- Disclosure differences for certain nonpublic entities.

Those differences are discussed in greater detail in the FASB's Accounting Standards Update 2011-04, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs" (May 2011).

### STUDY QUESTION

1. Which of the following is a *true* statement about the fair value measurement framework set out in Topic 820 of the FASB Accounting Standards Codification®?
  - a. The framework specifies when an asset, liability, or other item has to be measured at fair value.
  - b. The framework establishes how to measure fair value if other GAAP guidance allows or requires a fair value measurement under the framework.
  - c. The framework sets forth a set of best practices for valuation.
  - d. The framework is fundamentally inconsistent with how fair value is measured under International Financial Reporting Standards (IFRSs).

### THE FAIR VALUE CONCEPT

The concept of a fair value measurement under the framework is broader than just the definition of fair value. Rather, you will learn in this chapter that the fair value concept envisions a hypothetical transaction in a context involving the attributes of the item bought or sold, the markets in which

the transaction could take place, the knowledge and motivation of the parties, and other relevant information. As this chapter addresses each aspect of the concept, keep in mind that it is the accumulation of the definitions and assumptions that drives the fair value measurement.

### Core Definition of Fair Value

To measure an item at fair value under GAAP, the reporting entity considers a hypothetical transaction from the perspective of a party that holds the item (if an asset) or owes the item (if a liability). The hypothetical transaction “occurs” at the measurement date.

**Fair Value**—The price that would be received to sell an asset or paid to transfer a liability in an **orderly transaction** between **market participants** at the measurement date. (Master Glossary term “Fair Value”; 820-10-20)

The core definition of fair value includes two other defined terms: **orderly transaction** and **market participant**.

A transaction is orderly when it isn't forced on the parties and involves time for the exchange of information.

**Orderly Transaction**—A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). (Master Glossary term “Orderly Transaction”; 820-10-20; 820-10-35-54I and 54J)

GAAP uses the term **market participant** to denote a buyer (or seller) that is: (Master Glossary term “Market Participant”; 820-10-20; 820-10-35-5; 820-10-35-9)

- Party to a transaction in the **principal (or most advantageous) market**
- Independent of the other party to the transaction
- Knowledgeable about the item and transaction
- Able to enter into the transaction
- Willing to enter into the transaction

The idea that a market participant is willing to enter into a transaction emphasizes that the party is not being forced into the transaction or otherwise compelled to buy or sell. (Master Glossary term “Market Participant”; 820-10-20)

The knowledge a market participant has about an item and transaction comes from all available information, which would include information

that party could get by performing the customary due diligence for such a transaction. (Master Glossary term “Market Participant”; 820-10-20) That knowledge is based on market conditions current at the measurement date and includes the attributes of the item such as where it is located and any restriction on its use or sale. (820-10-35-2B; 820-10-35-3)

### OBSERVATION

This chapter uses the word “item” to refer to what is being measured at fair value. Most of the GAAP on fair value measurements refers to “asset or liability.” In fact, the item (unit of account) being measured might be an asset, a liability, a group of assets, a group of liabilities, a group of assets and liabilities, the net position of a group of assets and liabilities, a business comprising both assets and liabilities, a reporting unit, and so on. More on unit of account later in the chapter. In the meantime, keep in mind that “item” is shorthand and that the actual unit of account matters. (820-10-35-2C through 2E)

### EXAMPLE 1

#### RESTRICTION ON SALE OF EQUITY INSTRUMENT

You just learned that a market participant considers all information about an item and its attributes, including any restriction on the use or sale of the item. One example GAAP gives of the effects of a restriction, involves measurement of the fair value of a financial asset.

Specifically, say an entity holds an equity instrument that, under United States Securities and Exchange Commission (SEC) rules, the entity can sell only to another qualified investor. GAAP views the restriction as a characteristic of the item that has to be considered in measuring the item’s fair value. (820-10-55-52)

With respect to a restricted equity instrument, the entity could first look to the quoted price of an unrestricted equity instrument of the same issuer. If that other instrument is otherwise identical but for the restriction, fair value could be estimated based on the quoted price adjusted for the amount a buyer would demand due to the restriction. (820-10-55-52)

Among other relevant factors (both qualitative and quantitative) the entity would need to consider in determining the amount of adjustment are: (820-10-55-52)

- The nature of the restriction
- The duration of the restriction
- The potential buyers given the restriction

Ultimately, the measurement of the adjustment amount is grounded in the question: “What would a **market participant** do?”

GAAP defines **market participant** to exclude a related party. For example, a buyer and a seller that are market participants in a given transaction cannot meet the GAAP definition of **related parties** for the hypothetical transaction to represent fair value. (Master Glossary term “Market Participant”; 820-10-20)

**Related Party**—With respect to one party, a second party that is:

- An affiliate of the first party
- An equity method investee of the first party (or a second party that would be an equity method investee absent the first party’s election under GAAP to measure the investment at fair value [see the Fair Value Option Subsection of Section 825-10-15])
- A trust for the benefit of the first party’s employees (for example, a pension trust or profit-sharing trust)
- A principal owner of the first party (or an immediate family member of that principal owner)
- A member of management of the first party (or an immediate family member of that member of management)
- A party with which the first party may deal when either party controls or can significantly influence the management or operating policies of the other such that one of the parties could be prevented from fully pursuing its own separate interests
- A party that can significantly influence the management or operating policies of either of the parties
- A party that has an ownership interest in one of the parties and can significantly influence the other party such that one of the parties could be prevented from fully pursuing its own separate interests. (Master Glossary entry “Related Parties”)

For additional guidance on related parties, see FASB Accounting Standards Codification® Topic 850, *Related Party Disclosures*.

## STUDY QUESTION

2. Which of the following is **not** an important aspect of the fair value concept?
- a. The transaction isn’t forced on the parties and involves time for the exchange of information.
  - b. The price reflects an actual transaction that has been completed.
  - c. The independent parties are willing and able to enter into the transaction.
  - d. The price is as of the date fair value is being measured.

### Principal Market Versus Most Advantageous Market

An item may be bought or sold in more than one market. Which market should an entity look to for a price? GAAP requires that an entity look to the market with the greatest volume and level of activity for the item (the principal market) to which the entity has access at the measurement date. (Master Glossary term “Principal Market”; 820-10-20; 820-10-35-6)

**Principal Market**—The market with the greatest volume and level of activity for the asset or liability. (Master Glossary term “Principal Market”; 820-10-20)

If no one market fits the definition of a principal market, then GAAP requires that the entity look at all the markets to which it has access at the measurement date and determine which market will give the entity the most advantageous price (the **most advantageous market**). (Master Glossary term “Most Advantageous Market”; 820-10-20)

**Most Advantageous Market**—The market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account **transaction costs** and **transportation costs**. (Master Glossary term “Most Advantageous Market”; 820-10-20)

An entity can presume that the market in which it would buy or sell an item is the market to which it should look in measuring fair value unless there is information available to the contrary. (820-10-35-5A) An entity has to assess its situation further if, for example:

- The entity uses more than one market.
- A market other than the one the entity uses meets the definition of a principal market.

The concept of the principal (or most advantageous) market is specific to the reporting entity. That is, it is limited to the markets to which the reporting entity has access at the measurement date (820-10-35-6A). As a result, different entities will identify different markets as the principal market or most advantageous market for different hypothetical transactions.

**EXAMPLE 2**

**MULTIPLE MARKETS**

Let’s consider an example based on the one set out in 820-10-55-43 through 55-45A.

Entity needs to measure the fair value of a nonfinancial asset (a commodity) it holds. As of the measurement date, Entity has access to two markets – Market A and Market B. To access each market, Entity has to transport the nonfinancial asset to market. Entity has the following information for a hypothetical transaction as of the measurement date.

	<b>Market A</b>	<b>Market B</b>
Price	\$26	\$25
Transportation costs	<u>      (2)</u> \$24	<u>      (2)</u> \$23

Because Entity sells nonfinancial assets in both markets (that is, more than one market), it can’t look to one market as the presumed market for its hypothetical transaction. (820-10-35-5A) Rather, Entity has to identify its principal market or, if no principal market exists, the most advantageous market.

**Scenario 1: Market A is the Principal Market**

If Market A is the market with the “greatest volume and level of activity for the asset” (that is, the **principal market**), then Entity would measure the fair value of the nonfinancial asset at \$24. In other words, fair value is the price in the principal market (Market A) of \$26 adjusted for transportation costs of \$2 (or \$26 minus \$2 equals \$24). Transportation cost is an attribute of Entity’s nonfinancial asset (a commodity that must be transported to market) and, thus, the price in that market is adjusted for the transportation cost. (820-10-35-9C)

**Scenario 2: No Principal Market**

If Entity can’t consider either market its principal market, then it has to determine which is the **most advantageous market**. The most advantageous market is the market that “maximizes the amount that would be received to sell the asset... after taking into account transaction costs and transportation costs.” Entity has the following additional information about transaction costs for a hypothetical transaction as of the measurement date.

	<b>Market A</b>	<b>Market B</b>
Price	\$26	\$25
Transportation costs	<u>      (2)</u> \$24	<u>      (2)</u> \$23
Transaction costs	<u>      (3)</u> <u>      \$21</u>	<u>      (1)</u> <u>      \$22</u>

The net amount received in the hypothetical transaction in Market B is greater than the net amount for Market A. That is, Market B maximizes the amount that would be received after transaction and transportation costs and, thus, Market B is Entity’s most advantageous market for sale of the nonfinancial asset.

Transaction costs enter into the determination of which market is the most advantageous but don't otherwise affect the measurement of fair value because—unlike transportation—GAAP does not consider them to be an attribute of the nonfinancial asset being measured. (820-10-35-9B)

Entity would measure the fair value of the nonfinancial asset at \$23. In other words, the price in the most advantageous market (Market B) of \$25 adjusted for transportation costs of \$2 (or \$25 minus \$2 equals \$23).

(820-10-55-43 through 55-45A)

### Transaction Costs Versus Transportation Costs

In the preceding example, you learned how transaction costs are relevant to determining which of the multiple markets is the most advantageous market. You also learned that, if location is an attribute of an asset (such as a commodity), the market price is adjusted for the cost to transport the item to that market. That is, if location is a characteristic of an asset, then **transportation cost** is part of the amount being measured.

As you learned earlier, when an item is measured at fair value, the market participant concept requires the entity to consider all of the item's characteristics. A **transaction cost** is not an attribute of an asset or a liability (the item) and, therefore, is not part of the amount being measured. (820-10-35-9B)

How does GAAP define those costs?

**Transaction Costs**—The costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria:

- a. They result directly from and are essential to that transaction.
- b. They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made (similar to costs to sell, as defined in paragraph 360-10-35-38).

GAAP distinguishes a **transportation cost** from a transaction cost. (820-10-35-9B)

**Transportation Costs**—The costs that would be incurred to transport an asset from its current location to its principal (or most advantageous) market.

Again, if the location of the asset is a characteristic—for example, if the asset is a commodity that must be transported to market—then transportation cost is part of amount being measured. (820-10-35-9C)

### The Exit Price

You have learned that an important point in understanding GAAP's concept of fair value is to understand that the price used to measure an item depends on context and perspective; that is, you have learned about the concepts of an orderly transaction, a market participant, and a principal (or most advantageous) market.

Another important concept under GAAP's fair value measurement framework is that the price an entity pays to acquire an asset (an **entry price**) is not the same as the price the entity receives to sell that asset (an **exit price**). Similarly, the price an entity receives to incur a liability (an entry price) is not the same as the price the entity would pay to transfer that liability (an exit price). (820-10-30-2)

**Entry Price**—The price paid to acquire an asset or received to assume a liability in an exchange transaction. (Master Glossary term “Entry Price”; 820-10-20)

**Exit Price**—The price that would be received to sell an asset or paid to transfer a liability. (Master Glossary term “Exit Price”; 820-10-20)

GAAP focuses on the **exit price** because that objective “embodies current expectations about the future inflows associated with the asset and the future outflows associated with the liability from the perspective of market participants.” (FASB Statement No. 157, *Fair Value Measurements*, paragraph C26)

#### NOTE

Paragraph C26 of FASB Statement No. 157 was not codified because it describes the basis for the FASB's conclusions and is of historical interest only.

When an item is measured at fair value under GAAP, the reporting entity considers a hypothetical transaction from the perspective of a party that holds the item (if an asset) or owes the item (if a liability). That is, fair value is the price the party would receive to sell that asset (an exit price) or to transfer that liability (an exit price) in the hypothetical transaction.

Because GAAP focuses on an exit price, the transaction price at the time an item is initially measured may or may not represent fair value (820-10-30-3). If an item is initially measured at fair value but the transaction price differs from fair value, the entity has to recognize a gain or loss in earnings unless the GAAP requiring the fair value measurement explicitly states otherwise. (820-10-30-6)

What causes a **transaction price** to differ from fair value (the **exit price**)? By definition, fair value is not the transaction price if the transaction price reflects: (820-10-30-3A)

- A transaction between **related parties**.
- A transaction made under duress or forced (for example, if the seller is having financial difficulty).
- Transaction costs.
- A transaction in a market other than the **principal (or most advantageous) market**.
- More than one item (a **unit of account** issue).

In the last circumstance, the unit of account represented by the exit price may be just one component of the transaction, with the other components measured separately. This can happen with a business combination, for example. (820-10-30-3A)

#### PRACTICE POINTER

Although GAAP excludes related parties from the concept of market participants, an entity can use the price in a related-party transaction as an input to a fair value measurement if the entity “has evidence that the transaction was entered into at market terms.” (Master Glossary term “Market Participants”; 820-10-20)

#### STUDY QUESTIONS

3. Which of the following is a *true* statement about markets and fair value measurement?
  - a. The most advantageous market is the market with the greatest volume and level of activity for an item.
  - b. A transaction cost is relevant both in identifying the most advantageous market and determining the price in that market.
  - c. Assuming an item has to be transported to market, the related transportation cost is relevant only to determining the price in the principal market.
  - d. If an entity only has access to one market at the measurement date, the principal market versus most advantageous market distinction is irrelevant.
  
4. Which of the following defines the term “exit price”?
  - a. The price in the nearest local market for the quantity normally sold, less the estimated cost of the sale.
  - b. The price paid to acquire an asset or received to assume a liability in an exchange transaction.
  - c. The price that would be received to sell an asset or paid to transfer a liability.
  - d. The price that must be paid upon exercise of an option.

## VALUATION APPROACHES AND RELATED INPUTS

To measure **fair value**, GAAP requires that the entity use a **valuation approach**: (820-10-35-25)

- That is appropriate in the circumstances
- For which sufficient inputs are available
- That maximizes the use of relevant **observable inputs**
- That minimizes the use of **unobservable inputs**

GAAP identifies three widely used approaches to valuation:

- The **cost approach**, which focuses on the cost of replacing the item's service capacity
- A **market approach**, which uses a market transaction for a similar (or identical) item
- An **income approach**, which centers on the current, discounted amount of market-based expectations of future flows.

GAAP acknowledges that a fair value measurement might involve the use of more than one of these valuation approaches; for example, if the item being measured is a **reporting unit** (820-10-35-24A). If more than one valuation approach is used, the entity has to evaluate the reasonableness of the range of values generated and select the point within that range that is the most representative in the circumstances. (820-10-35-24B)

### PRACTICE POINTER

What if an entity changes its valuation technique or the way it applies that technique? For example, say an entity uses more than one approach but then changes the weight it gives to the various approaches? Any change in valuation approach (or its application) is a change in accounting estimate and the entity has to treat it as such. Guidance on a change in accounting estimate is provided in Topic 250, *Accounting Changes and Error Corrections*; however, the disclosure requirements in that Topic do not apply. (820-10-35-26; 250-10-45-17; 250-10-50-5)

GAAP provides additional guidance on valuation in the case of a significant decrease in the volume or level of activity for an item in relation to normal market activity. (820-10-35-54C through 35-54H)

### OBSERVATION

GAAP uses the words "technique" and "approach" interchangeably to refer to a way in which an entity estimates values for an item. For consistency, this chapter uses the word "approach."