

## EITF ABSTRACTS

Issue No. 02-13

**Title:** Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in FASB Statement No. 142

**Date Discussed:** September 11–12, 2002

**References:** FASB Statement No. 109, *Accounting for Income Taxes*  
FASB Statement No. 141, *Business Combinations*  
FASB Statement No. 141 (revised 2007), *Business Combinations*  
FASB Statement No. 142, *Goodwill and Other Intangible Assets*  
FASB Statement No. 164, *Not-for-Profit Entities: Mergers and Acquisitions*

### ISSUE

1. Statement 142 requires goodwill to be tested for impairment at the reporting unit level at least annually using a two-step impairment test. Step 1 of the test is a screen used to identify whether a goodwill impairment may exist. In Step 1, an entity compares the fair value of a reporting unit with its carrying amount. If a reporting unit's carrying amount exceeds its fair value, a goodwill impairment may exist. Step 2 of the test must then be performed to measure the amount of impairment, if any. In Step 2, an entity compares the implied fair value of goodwill with its carrying amount. An impairment loss is measured by the excess of the carrying amount of goodwill over its implied fair value. The implied fair value of goodwill should be determined in the same manner that goodwill is measured in a business combination under Statement 141(R) (or in an acquisition of a business or nonprofit activity by a not-for-profit entity under Statement 164). That is, an entity must allocate the fair value of a reporting unit to the assets and liabilities of that unit (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business combination or in an acquisition of a business or

nonprofit activity by a not-for-profit entity and the fair value of the reporting unit was the price paid to acquire the reporting unit. [Note: See STATUS section.]

2. Pursuant to Statement 142, *all* goodwill acquired in a business combination or in a combination of not-for-profit entities—that is, in an acquisition of a business or nonprofit activity by a not-for-profit entity or a merger of not-for-profit entities—must be assigned to one or more reporting units. [Note: See STATUS section.] In addition, an entity’s assets (excluding goodwill) and liabilities, including corporate assets and liabilities, should be assigned (or allocated) to one or more reporting units if both of the following two criteria are met:

- a. The asset will be employed in or the liability relates to the operations of a reporting unit.
- b. The asset or liability will be considered in determining the fair value of the reporting unit.

In the context of recognizing and measuring impairment of goodwill, questions have arisen regarding how an entity should account for differences between the book and tax bases of assets and liabilities (that is, deferred tax balances) in determining (a) a reporting unit’s fair value, (b) a reporting unit’s carrying amount, and (c) the implied fair value of goodwill.

3. The issues are:

Issue 1—Whether the fair value of a reporting unit should be estimated by assuming that the unit would be bought or sold in a nontaxable transaction versus a taxable transaction

Issue 2—Whether deferred income taxes should be included in the carrying amount of a reporting unit for purposes of Step 1 of the Statement 142 goodwill impairment test

Issue 3—For purposes of determining the implied fair value of a reporting unit's goodwill in Step 2 of the Statement 142 goodwill impairment test, what income tax bases an entity should use for a reporting unit's assets and liabilities in order to measure deferred tax assets and liabilities. That is, should an entity use the existing income tax bases or assume new income tax bases for the unit's assets and liabilities.

#### **EITF DISCUSSION**

4. The Task Force reached a consensus on Issue 1 that the determination of whether to estimate the fair value of a reporting unit by assuming that the unit could be bought or sold in a nontaxable transaction versus a taxable transaction is a matter of judgment that depends on the relevant facts and circumstances and must be evaluated carefully on a case-by-case basis. In making that determination, an entity should consider (a) whether the assumption is consistent with those that marketplace participants would incorporate into their estimates of fair value, (b) the feasibility of the assumed structure, and (c) whether the assumed structure results in the highest economic value to the seller for the reporting unit, including consideration of related tax implications.

5. The Task Force observed that in determining the feasibility of a nontaxable transaction, an entity should consider, among other factors, (a) whether the reporting unit could be sold in a nontaxable transaction and (b) whether there are any income tax laws

and regulations or other corporate governance requirements that could limit an entity's ability to treat a sale of the unit as a nontaxable transaction.

6. The Task Force reached a consensus on Issue 2 that deferred income taxes should be included in the carrying value of the reporting unit, regardless of whether the fair value of the reporting unit will be determined assuming it would be bought or sold in a taxable or nontaxable transaction.

7. The Task Force reached a consensus on Issue 3 that an entity should use the income tax bases of a reporting unit's assets and liabilities implicit in the tax structure assumed in its estimation of fair value of the reporting unit in Step 1. That is, an entity should use its existing income tax bases if the assumed structure used to estimate the fair value of the reporting unit was a nontaxable transaction, and it should use new income tax bases if the assumed structure was a taxable transaction.

8. The Task Force observed that in performing Step 2 of the goodwill impairment test, the implied fair value of a reporting unit's goodwill is determined in the same manner that the amount of goodwill recognized in a business combination accounted for in accordance with Statement 141(R) is determined. (This also is the method by which the amount of goodwill recognized in an acquisition of a business or nonprofit activity by a not-for-profit entity is determined in accordance with Statement 164.) Paragraph 26 of Statement 141(R) indicates that a deferred tax liability or asset shall be recognized for differences between the assigned values and the income tax bases of the recognized assets acquired and liabilities assumed in a business combination in accordance with paragraph 30 of Statement 109.

(Paragraph 43 of Statement 164 provides similar guidance.) [Note: See STATUS section.] To the extent present, tax attributes that will be transferred in the assumed tax structure, such as operating loss or tax credit carryforwards, should be valued consistent with the guidance contained in paragraph 135 of Statement 109.

9. The following examples demonstrate the consensuses reached in this Issue. Note that these examples may not necessarily be indicative of actual income tax liabilities that would arise in the sale of a reporting unit or the relationship of those liabilities in a taxable versus nontaxable structure.

### **Example 1**

Company A is performing a goodwill impairment test relative to Reporting Unit at December 31, 20X2. Reporting Unit has the following assets and liabilities:

- Net assets (excluding goodwill and deferred income taxes) of \$60 with a tax basis of \$35
- Goodwill of \$40
- Net deferred tax liabilities of \$10.

Company A believes that it is feasible to sell Reporting Unit in either a nontaxable or a taxable transaction. Company A could sell Reporting Unit for \$80 in a nontaxable transaction or \$90 in a taxable transaction. If Reporting Unit were sold in a nontaxable transaction, Company A would have a current tax payable resulting from the sale of \$10. Assuming a tax rate of 40 percent, if Reporting Unit were sold in a taxable transaction, Company A would have a current tax payable resulting from the sale of \$22 ( $[\$90 - 35] \times 40\%$ ). The fair value of the net tangible and identifiable intangible assets in Reporting Unit is \$65, before consideration of deferred income taxes.

### Issue 1

In Step 1 of the impairment test, Company A concludes that it would recognize the highest economic value from Reporting Unit by selling it in a nontaxable transaction based on the following evaluation of its expected after-tax proceeds:

	<u>Nontaxable</u>	<u>Taxable</u>
Gross proceeds (fair value)	\$ 80	\$ 90
Less: taxes arising from transaction	<u>(10)</u>	<u>(22)</u>
Economic value to Company A	<u>\$ 70</u>	<u>\$ 68</u>

### Issue 2

In Step 1 of the impairment test, Company A would determine the carrying value of Reporting Unit as follows:

Net assets	\$ 60
Goodwill	40
Deferred taxes	<u>(10)</u>
Carrying value	<u>\$ 90</u>

### Issue 3

Reporting Unit fails Step 1 of the goodwill impairment test as its carrying value (\$90) exceeds its fair value (\$80 assuming a nontaxable transaction). Company A must perform Step 2 of the goodwill impairment test. Because Company A assumed that Reporting Unit would be sold in a nontaxable transaction, the analysis in Step 2 is as follows:

**Assumed Allocation of Fair Value  
(Purchase Price)**

---

Fair value of Reporting Unit	\$ 80
Less fair value of net tangible and identifiable intangible assets	(65)
Plus deferred tax liabilities (\$65 – \$35 = \$30 × 40% = \$12)	<u>12</u>
Implied fair value of goodwill	<u>\$ 27</u>

Reporting Unit must recognize a goodwill impairment of \$13 (determined as the carrying value of goodwill of \$40 compared to its implied fair value of \$27).

**Example 2**

Company A is performing a goodwill impairment test relative to Reporting Unit at December 31, 20X2. Reporting Unit has the following assets and liabilities:

- Net assets (excluding goodwill and deferred income taxes) of \$60 with a tax basis of \$35
- Goodwill of \$40
- Net deferred tax liabilities of \$10.

Company A believes that it is feasible to sell Reporting Unit in either a nontaxable or a taxable transaction. Company A could sell Reporting Unit for \$65 in a nontaxable transaction or \$80 in a taxable transaction. If Reporting Unit were sold in a nontaxable transaction, Company A would have a current tax payable resulting from the sale of \$4. Assuming a tax rate of 40 percent, if Reporting Unit were sold in a taxable transaction, Company A would have a current tax payable resulting from the sale of \$18 ( $[\$80 - 35] \times 40\%$ ). The fair value of the net tangible and identifiable intangible assets in Reporting Unit is \$65, before consideration of deferred income taxes.

### Issue 1

In Step 1 of the impairment test, Company A concludes that it would realize the highest economic value from Reporting Unit by selling it in a taxable transaction. This conclusion was based on the following evaluation of economic value:

	<b><u>Nontaxable Transaction</u></b>	<b><u>Taxable Transaction</u></b>
Gross proceeds (fair value)	\$ 65	\$ 80
Less: taxes arising from transaction	<u>(4)</u>	<u>(18)</u>
Economic value to Company A	<u>\$ 61</u>	<u>\$ 62</u>

### Issue 2

Deferred taxes related to the net assets of Reporting Unit should be included in the carrying value of Reporting Unit. Accordingly, in Step 1 of the impairment test Company A would determine the carrying value of Reporting Unit as follows:

Net assets	\$ 60
Goodwill	40
Deferred income taxes	<u>(10)</u>
Carrying value	<u>\$ 90</u>

Reporting Unit fails Step 1 because its carrying value (\$90) exceeds its fair value (\$80); therefore, Company A must perform Step 2 of the goodwill impairment test. Because Company A assumed that Reporting Unit would be sold in a taxable transaction, the calculation of the implied fair value of goodwill in Step 2 of the impairment analysis is as follows:

Fair value of Reporting Unit	\$ 80
Less:	
Fair value of net tangible and intangible assets	(65)
Deferred income taxes	<u>—</u>
Implied fair value of goodwill	<u>\$ 15</u>

Reporting Unit must recognize a goodwill impairment of \$25 (determined as the carrying value of goodwill of \$40 compared to its implied fair value of \$15).

10. The consensuses in this Issue should be applied prospectively in performing either Step 1 or Step 2 of goodwill impairment tests after September 12, 2002.

## **STATUS**

11. Statement 141(R), which was issued in December 2007, replaces Statement 141 and does not affect the consensus guidance reached in this Issue.

12. Statement 164, issued in April 2009, makes the guidance in Statements 141(R) and 142 fully applicable to not-for-profit entities.

13. No further EITF discussion is planned.

Suggested Index Entries for Issue No. 02-13, “Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in FASB Statement No. 142”

GOODWILL

Impairment

. . Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in Statement 142 02-13

INCOME TAXES

Deferred Tax Assets/Liabilities

. . Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in Statement 142 02-13

Deferred Taxes

. . Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in Statement 142 02-13

IMPAIRMENT

See Goodwill

INTANGIBLE ASSETS

Goodwill

. . Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in Statement 142 02-13