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Is a Reported Goodwill Impairment Loss Really a Goodwill Impairment Loss? A Financial Reporting Case on Evaluating the Efficacy of Authoritative Guidance

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ABSTRACT: While undergraduate financial reporting courses focus primarily on the application of generally accepted accounting principles and the mechanics of accounting treatments, graduate-level courses should motivate students to explore standard-setting's theoretical perspective and to develop a more rigorous understanding of accounting issues not necessarily discussed in textbooks, but included, implicitly or explicitly, in the authoritative guidance. Anecdotal evidence suggests that accounting students face difficulties transitioning from the undergraduate setting to the higher expectations common in graduate accounting programs and the workplace. This hypothetical case provides an interesting scenario on goodwill impairment to facilitate the development of students' understanding of accounting theory and its connection to professional research skills. While students are accustomed to computing goodwill impairment losses from knowledge acquired in undergraduate financial accounting courses, this topic contains interesting theoretical and practical issues and serves as a salient example of the analysis of interesting accounting issues possible at the graduate level.

Keywords: accounting theory; professional accounting research; goodwill impairment.

I. THE CASE

Background

AM Enterprises (AM), a private global conglomerate of consumer product manufacturers in the landscaping/gardening space, purchased 100 percent of the stock of two companies, ZD Corporation (ZD) and Hope Industries (Hope), in January 2015. This was a bold move for AM, as the acquisitions represented a new venture for the company and the entrance into a new segment in which it had no experience. As a result of the transactions, AM initially reported \$3.2 million of goodwill on its consolidated balance sheet, \$2 million relating to the acquisition of ZD and \$1.2 million relating to Hope.

The New Segment

ZD produces and sells high-end household accessories in retail markets across the United States. The company's top-selling products are its premium lines of kitchen and bathroom cabinet hardware and light fixtures. ZD's products are primarily sold through large retailers and wholesalers in large metropolitan areas. In recent years, however, company management has made a focused effort on selling directly to consumers through the company website. Accordingly, ZD marketing personnel have developed strategic advertising approaches to direct customers to its commerce website. Management anticipates that this initiative will greatly improve product margins and, thus, it is expected that direct-to-consumer sales will surpass sales through retailers/wholesalers within the next five years.

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Hope is a manufacturer of premium home décor with an emphasis on quality decorative linens and unique wall decorations. The company mainly sells its products in company-owned retail stores located in upscale shopping districts in urban populations. However, a limited line of Hope products can be found at other select brick-and-mortar retailers. Additionally, the company generates a small amount of revenue via its website. Due to the nature of the company products, Hope management has faced several challenges in developing a greater online presence, yet these struggles have also hampered the expansion of its competitors. Ultimately, management has plans to develop brand awareness that will allow for brick-and-mortar expansion into more suburban areas.

Upon the purchase of ZD and Hope, AM formally established a new segment, Household Goods, for financial reporting purposes. The segment is headed by an executive team, which provides oversight of the management teams at both companies. AM's corporate controller, Tracy Roberts, was promoted to Vice President of Finance—Household Goods following the merger.

From 2015 to 2018, the strategic acquisitions proved to be wise investments, as both ZD and Hope posted significant growth and continued to produce unique products each year. In 2019, however, the companies moved in opposite directions. ZD continued its impressive growth. Hope, on the other hand, encountered significant competition and regulatory setbacks, leading to diminished profitability and derailing the company's strong start under AM's control. However, Hope did benefit from some strategic land acquisitions in prior years that have appreciated considerably in value.

Goodwill

Prior to the acquisitions, in response to changes in generally accepted accounting principles in the United States (i.e., U.S. GAAP) and in the interest of effective portfolio management, the company developed a policy of subjecting each reporting unit to formal quantitative impairment tests of goodwill every five years, with the first such test to take place for the fiscal year 2019 financial statements. Due to the success of ZD and Hope each year and in comparison to competitors prior to 2019, AM financial reporting personnel concluded, year after year, that a formal quantitative goodwill impairment test was unnecessary.

However, pursuant to the new policy, the company made preparations toward the end of 2019 to test all of its reporting units. In conjunction with these tests, Roberts indicated that multiple fixed asset groupings within Household Goods experienced significant declines in market value, and thus the segment personnel would be testing all fixed asset groupings for impairment. AM hired Dynamic Equity, a large consulting firm specializing in corporate valuation, to conduct appraisals that are necessary for the goodwill impairment testing process. In addition, Morgan Mickelson, AM's Director of Financial Reporting, requested financial information from the accounting records of ZD and Hope from Roberts, including relevant fair value information regarding both companies' assets and liabilities. That information, in conjunction with Dynamic's appraisal reports, will be used in goodwill impairment testing. Dynamic's reports highlighted December 31, 2019 fair values in the amounts of $11,339,000 and $10,000,000 for ZD and Hope, respectively.

At the time Mickelson made the request, Roberts was in the final stages of overseeing impairment tests of the segment's fixed assets, finalizing the valuation of inventory, and reviewing the impact of interest rate changes on the fair value of the company's bond obligations. Essentially, Roberts had compiled all of the necessary information for the consideration of these areas, and in the coming weeks, planned to run a final analysis to determine their impact on the financial statements. Roberts was confident that all of the other assets and liabilities were reported at appropriate amounts that approximated fair values. The preliminary 2019 Balance Sheet Summary for each company provided by Roberts is presented in Appendix A.

In addition, Roberts also provided relevant information related to the ongoing impairment testing of property, plant, and equipment, valuation of inventory, and consideration of bonds payable:

- Property, Plant, & Equipment, net, is reported at historical cost less accumulated depreciation (i.e., $15,000,000 for ZD) on the preliminary 2019 Balance Sheet Summary. The tables in Appendix B contain information Roberts has compiled for fixed asset impairment testing.
- Current Assets on the preliminary 2019 Balance Sheet Summary includes inventory reported with the last-in-first-out (LIFO) approach, using the dollar-value LIFO method applied to a single inventory cost pool. Relevant information for these cost pools compiled by Roberts for the analysis of inventory valuation is presented in Appendix C.
- ZD's Bonds Payable consists of a single issuance of 8,000 bonds, each with a face value of $1,000 and a maturity date of 12/31/2024. The bonds have a coupon rate of 6 percent (payable annually) and were issued at face value. At 12/31/19, the prevailing market rate was 5 percent. Hope's Bonds Payable includes a single issuance of 6,200 bonds, each with a face value of $1,000 and a maturity date of 12/31/2023. The bonds have a coupon rate of 4 percent (payable annually) and were issued at face value. At 12/31/19, the prevailing market rate was 5 percent.

II. REQUIREMENTS

1. This is the first year in which AM has implemented its policy of performing formal quantitative goodwill impairment tests. In preparation for the upcoming financial statement audit of AM and its subsidiaries, and for future audits, Mickelson would like you to provide documentation of the process that should be used in determining the appropriate goodwill valuation in accordance with U.S. GAAP.

   Please provide a step-by-step list or decision diagram/flowchart that details the general process of assessing goodwill impairment. There are at least three major decision steps within the process. Each major decision, though, has its own set of steps. Each step should be accompanied by a decision along with a justification for the course of action as indicated by the Financial Accounting Standards Board *Accounting Standards Codification*. You should prepare your documentation such that it can be applied to a broad array of scenarios involving goodwill impairment and, thus, it must extend beyond the specific fact patterns presented in the case text.
2. Based upon your knowledge of the facts presented in the case and appropriate authoritative guidance, Mickelson has asked you to oversee the testing of goodwill impairment for ZD and Hope and to ultimately determine, based upon the information provided by Roberts, the valuation of goodwill and the related impairment loss, if any, for the Household Goods segment. Please provide any relevant calculations.
3. Beyond the company's compliance with U.S. GAAP, AM's institutional shareholders are most concerned with the quality of the financial information that they are provided, and its ability to affect their investing decisions. In past shareholder meetings, AM investors have been particularly interested in goodwill valuations of recent acquisitions, given AM's role in the market as a conglomerate. In anticipation of questions surrounding goodwill at the upcoming shareholder meetings, Mickelson would like you to provide a written, maximum two-page, single-spaced memo containing (1) an explanation of why you chose (or did not choose) to early adopt the goodwill impairment testing provisions of ASU 2017-04; and (2) an evaluation of the efficacy of the reported goodwill amount from Requirement 2 in contributing to the quality of the information reported to AM shareholders and the public. Be sure to consider differences between the specific goodwill impairment guidance and the related theoretical guidance from the Financial Accounting Standards Board Conceptual Framework, along with the political and practical forces that may have caused them.

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APPENDIX A

Preliminary Balance Sheet Summaries

Panel A: ZD Corporation

ZD Corporation
Balance Sheet Summary
December 31, 2019

Assets	
Current Assets	25,000,000
Property, Plant, & Equipment, net	15,000,000
Total Assets	**40,000,000**
Liabilities	
Current Liabilities	21,000,000
Bonds Payable (maturity date–12/31/2024)	8,000,000
Total Liabilities	**29,000,000**
Stockholders' Equity	
Common Stock/Additional Paid-In-Capital	8,000,000
Retained Earnings	3,000,000
Total Stockholders' Equity	**11,000,000**
Total Liabilities and Stockholders' Equity	**40,000,000**

Panel B: Hope Industries

Hope Industries
Balance Sheet Summary
December 31, 2019

Assets	
Current Assets	16,500,000
Property, Plant, & Equipment, net	11,500,000
Total Assets	**28,000,000**
Liabilities	
Current Liabilities	13,800,000
Bonds Payable (maturity date–12/31/2023)	6,200,000
Total Liabilities	**20,000,000**
Stockholders' Equity	
Common Stock/Additional Paid-In-Capital	10,000,000
Retained Earnings	(2,000,000)
Total Stockholders' Equity	**8,000,000**
Total Liabilities and Stockholders' Equity	**28,000,000**

APPENDIX B

Property, Plant, and Equipment Information

Panel A: ZD Corporation

Asset Grouping[a]	Book Value	Fair Market Value	Sum of Undiscounted Future Cash Flows
1	1,250,000	800,000	1,500,000
2	3,400,000	3,600,000	4,200,000
3	960,000	850,000	900,000
4	1,080,000	900,000	1,200,000
5	3,800,000	3,850,000	3,900,000
6	1,600,000	1,750,000	2,000,000
7	440,000	300,000	400,000
8	820,000	600,000	1,000,000
9	750,000	860,000	980,000
10	900,000	1,075,000	1,200,000
	15,000,000	**14,585,000**	**17,280,000**

[a] Groups based upon lowest level in which related cash flows are independent of other assets.

Panel B: Hope Industries

Asset Grouping[a]	Book Value	Fair Market Value	Sum of Undiscounted Future Cash Flows
1	4,180,000	4,265,000	4,850,000
2	1,200,000	900,000	1,100,000
3	865,000	880,000	1,200,000
4	2,085,000	2,980,000	3,470,000
5	1,430,000	1,880,000	2,200,000
6	295,000	1,895,000	2,800,000
7	1,445,000	1,600,000	2,150,000
	11,500,000	14,400,000	17,770,000

[a] Groups based upon lowest level in which related cash flows are independent of other assets.

APPENDIX C

Inventory Information

Panel A: ZD Corporation

Dollar-Value LIFO Cost	Replacement Cost	Net Realizable Value	Net Realizable Value Less Normal Profit Margin
5,000,000	4,100,000	6,000,000	4,800,000

Panel B: Hope Industries

Dollar-Value LIFO Cost	Replacement Cost	Net Realizable Value	Net Realizable Value Less Normal Profit Margin
3,700,000	3,850,000	4,600,000	3,300,000