Fair Value Fundamentals– Business Combinations and Asset Impairments

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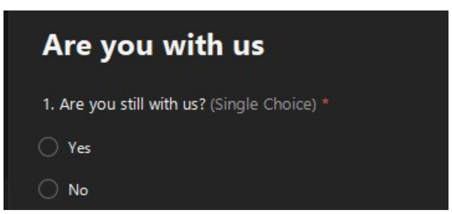

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- **Once you are logged in please do not log out even during breaks.**

Unit 1

Fair Value–Topic 820 Fundamentals

Learning Objectives

- Describe fair value fundamentals
- Apply the fair value framework
- Recognize and measure accounting fair values
- Apply the fair value hierarchy
- Prepare fair value disclosures

Fair Value Definition

- Fair value is defined as 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.

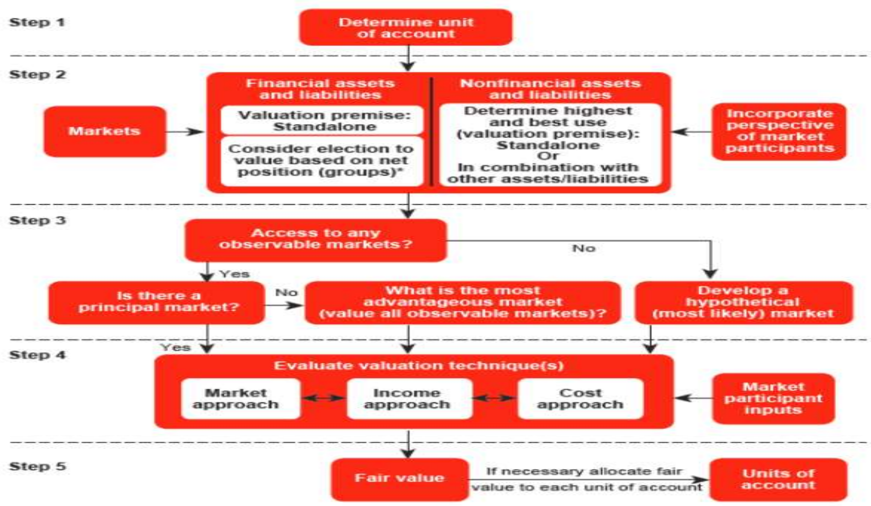
Fair Value

1. Topic 820 impacts the "how" of fair value accounting, not the "when."

2. Topic 820 distinguishes between assets and liabilities measured at fair value on a recurring basis and those measured at fair value on a non-recurring basis.

Fair Value Framework

Framework for application of the fair value standards



Fair Value Framework

1. Determine the unit of account
2. Determine the valuation premise
3. Determine the markets for the valuation premise
4. Applying the appropriate valuation technique
5. Determine the fair value

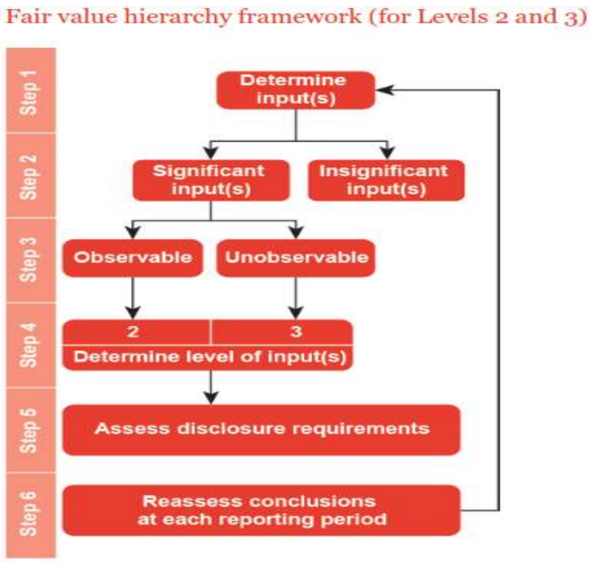
Initial Fair Value Measurement

1. When an asset is acquired or a liability is assumed in an exchange transaction, the transaction price is the entry price, i.e., "what you paid."
2. Under Topic 820, the basis for fair value measurement is the exit price, i.e., "what you could sell it for."
3. Consequently, the intuitive conclusion that the "cost" is the same as fair value on the acquisition date will not always be correct.

Fair Value Hierarchy

1. Level 1 – Observable inputs that reflect unadjusted quoted prices for identical assets or liabilities in active markets
2. Level 2 – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or indirectly
3. Level 3 – Unobservable inputs (e.g., a reporting entity's or other entity's own data)

Fair Value Hierarchy – Levels 2 and 3



Fair Value Hierarchy – Levels 2 and 3

1. Determine all inputs to valuation techniques
2. Determine which inputs are significant
3. Determine if significant inputs are observable or unobservable
4. Determine hierarchy level of the significant inputs
5. Assess disclosure required by the fair value standard
6. Reassess

Fair Value Hierarchy – Levels 2 and 3

1. Financial instruments valuation adjustment factors
2. Measuring liabilities at fair value

Fair Value Disclosures

The objective of the fair value disclosure requirements is to provide users of financial statements with information about assets and liabilities measured at fair value in the statement of financial position or disclosed in the notes to the financial statements including:

- The valuation techniques and inputs that a reporting entity uses to arrive at its measures of fair value, including judgments and assumptions that the entity makes
- The measurement uncertainty in the fair value measurements as of the reporting date
- How changes in fair value measurements affect an entity's performance and cash flows

Fair Value Disclosures – Recurring

1. The fair value measurement at the end of the reporting period
2. The level of the fair value hierarchy where the fair value measurements are categorized in their entirety (Level 1, 2, or 3)
3. For fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement
4. When a change in either or both a valuation approach and a valuation technique, the reporting entity must disclose that change and the reasons for making it

Fair Value Disclosures – Recurring

5. For fair value measurements categorized in Level 3 of the fair value hierarchy, a reporting entity must provide quantitative information about the significant unobservable inputs used in the fair value measurement.

   This quantitative information must include the range and weighted average (or median or arithmetic average) of significant unobservable inputs used to develop Level 3 fair value measurements. (Note: range and weighted average not required for non-public entities)

Fair Value Disclosures – Recurring

6. For fair value measurements categorized in Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately the following:

   - Total gains or losses for the period recognized in earnings and or other comprehensive income and the line item(s) in the statement of income or other comprehensive income which these gains or losses are recognized
   - Purchases, sales, issues, and settlements each disclosed separately
   - The amount of any transfers into or out of Level 3 of the fair value hierarchy and the reasons for those transfers. Transfers into Level 3 must be disclosed and discussed separately from transfers out of Level 3

Fair Value Disclosures – Recurring

7. For fair value measurements categorized in Level 3 of the fair value hierarchy, the amount of the total gains or losses for the period included in earnings and included in other comprehensive income that is attributable to the change in unrealized gains or losses relating to those assets and liabilities held at the end of the reporting period, and the line item(s) in the statement of comprehensive income which those unrealized gains or losses are recognized. (Note: not required by non-public entities)

Fair Value Disclosures – Recurring

8. For fair value measurements categorized in Level 3 of the fair value hierarchy, a narrative description of the measurement uncertainty of the fair value measurement from the use of significant unobservable inputs if those inputs reasonably could have been different at the reporting date. (Note: not required by non-public entities)

9. If the highest and best use of a non-financial asset differs from its current use, a reporting entity must disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use

10. For each class of assets and liabilities not measured at fair value in the statement of financial position but fair value is disclosed, a reporting entity must disclose the information required by 2, 3, and 9 above

Fair Value Disclosures – Recurring

Example

Fair Value Disclosures – Non-Recurring

1. The fair value measurement at the relevant measurement date and the reasons for the measurement
2. The level of the fair value hierarchy where the fair value measurements are categorized in their entirety (Level 1, 2, or 3)
3. For fair value measurements categorized within level 2 and level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement
4. When a change in either or both a valuation approach and a valuation technique, the reporting entity must disclose that change and the reasons for making it

Fair Value Disclosures – Non-Recurring

5. For fair value measurements categorized in Level 3 of the fair value hierarchy, a reporting entity must provide quantitative information about the significant unobservable inputs used in the fair value measurement

   This quantitative information must include the range and weighted average (or median or arithmetic average) of significant unobservable inputs used to develop Level 3 fair value measurements. (Note: range and weighted average not required for non-public entities)

Fair Value Disclosures – Non-Recurring

6. If the highest and best use of a non-financial asset differs from its current use, a reporting entity must disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use

7. For each class of assets and liabilities not measured at fair value in the statement of financial position but fair value is disclosed, a reporting entity must disclose the information required by 2, 3, and 6 above

Fair Value Disclosures – Non-Recurring

Example

Fair Value Disclosures

General Electric

Unit 2

Fair Value (Topic 820) and Business Combinations (Topic 805)

Learning Objectives

- Recognize, measure, present, and disclose fair value accounting for business combinations
- Determine business combination fair value
- Apply GAAP fair value guidance in Topic 805 – Business Combinations

Topic 805 – Business Combinations

- A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations
- The objective of Topic 805, Business Combinations, is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects

Topic 805 – Business Combinations

- Topic 805 requires that acquisitions (net assets) be recorded based on their fair values
- Following this guidance, the acquirer in a business combination must identify and determine fair value for all identifiable assets acquired, liabilities assumed, and non-controlling interests, as well as consideration paid at the acquisition date

Topic 805 – Business Combinations

<u>Complicating Factors</u>

- Determining whether the acquirer has actually purchased a business or a group of assets
- Recording fair values for assets or liabilities acquired that were not recognized on the acquiree's balance sheet prior to the transfer. This category includes certain internally generated intangibles, contingencies, favorable or unfavorable contracts, or a purchase price that is dependent on future events
- Dealing with subsequent changes in fair values recorded, such as when amounts collected on receivables differs from the fair value recorded for them
- Accounting for a controlling financial interest acquired in stages

Definition of a Business

- A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants

- To be considered a business, an integrated set must include, at a minimum, inputs and a substantive process that together significantly contribute to the ability to create output

Definition of a Business

<u>Elements</u>

1. Inputs – An input is any economic resource that creates, or has the ability to contribute to the creation of, outputs when one or more processes are applied to it

   Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees

Definition of a Business

Elements

2. Processes – A process is any system, standard, protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to contribute to the creation of outputs

   Examples include strategic management processes, operational processes, and resource management processes

   Processes may be documented or result from the intellectual capacity of a skilled workforce

   Administrative functions like accounting, billing, or payroll are not processes

Definition of a Business

Elements

3. Outputs – An output is the result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues

Acquisition Method

- Identify the acquirer
- Determine the acquisition date
- Determine the acquisition price
- Recognize and measure at fair value the identifiable assets acquired, the liabilities assumed, and any non-controlling interest as of the acquisition date
- Recognize and measure goodwill or a gain from a bargain purchase

Acquisition Method

<u>Definitions</u>

- Acquirer
- Acquiree
- Acquisition date
- Acquisition price
- Acquisition-related costs

Measurement Period

- Topic 805 contains guidance on adjustment of acquisition date fair values based on subsequent information obtained about facts or circumstances that existed on the acquisition date
- This period is called the measurement period and extends until complete information can be obtained – but no longer than 1 year

Measurement Principle

- The acquirer should measure the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree at their acquisition-date fair values
- There are certain limited exceptions to the recognition and measurement principles listed previously for certain topics where, due to the nature of the topic, the FASB Codification has specific guidance to address the unique nature of each. These topics include (next slides):

Measurement Principle

- Income taxes
- Employee benefits
- Indemnification assets
- Reacquired rights
- Assets held for sale
- Certain assets and liabilities arising from contingencies

Measurement Principle

- Leases
- Purchased financial assets with credit deterioration
- Share-based payment awards
- Contract assets and contract liabilities

Recognition and Measurement

- Accounts receivable
- Finished goods or merchandise inventory
- Raw materials or work in-process inventory
- Machinery and equipment
- Land
- Identifiable intangibles assets in general
- Software
- In-process research and development
- Liabilities

Unique Recognition and Measurement Issues in a Business Combination

- Assembled workforce
- Asset with a restriction on sale
- Asset with a restriction on use
- Contingent assets and liabilities
- Contingent consideration
- Favorable or unfavorable operating leases
- Measuring non-controlling interest at fair value

Goodwill – Initial Measurement

Sum of

- The fair value of the consideration transferred
- The fair value of any non-controlling interest
- The fair value of the acquirer's previously owned equity interest in a stage acquisition
- Less the net acquisition date fair value of assets and liabilities acquired in the acquisition

Goodwill – Initial Measurement

The authoritative guidance for intangible assets is organized into two main categories:

1. Intangibles (goodwill and other) that are considered to have an indefinite life – these assets are not amortized (unless a private company chooses the private company alternative to amortize goodwill), but they must be reviewed for impairment at least annually

2. Intangibles that have a definite life – these assets are amortized and are tested for impairment only if a triggering event occurs (similar to impairment of tangible property)

Goodwill – Initial Measurement

- Goodwill is defined 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.”
- It results from paying more than the fair value of the identifiable assets and liabilities when acquiring a business.
- Under Topic 805, if less than 100% of a business is acquired, the non-controlling interest is recorded at its fair value, and the goodwill recorded is not reduced for less than 100% ownership.

Goodwill – Initial Measurement

Examples

Disclosures

- Business combinations – General disclosures
- Business combinations – Disclosures for assets acquired, liabilities assumed, and non-controlling interests
- Business combinations – Disclosures for goodwill or gain from bargain purchase, including consideration transferred
- Business combinations – Intangibles goodwill and other

Business Combination Disclosures

Example

Unit 3

Fair Value (Topic 820) and Asset Impairments (Topics 350 and 360)

Learning Objectives

- Calculate goodwill impairments
- Calculate asset impairments
- Apply GAAP fair value guidance to Topic 350 – Intangibles and Topic 360 – Property, Plant, and Equipment

Asset Impairments

- Perform impairment tests on depreciated (or amortized) assets that are held and used only upon the occurrence of triggering events that suggest the assets may be impaired
- When performed, the tests are “cash-flow based” because impairment exists when carrying values exceed undiscounted cash flows expected from those assets during their remaining economic life
- This approach is appropriate for both fixed assets and definite-lived intangibles
- It makes sense that impairment is addressed only when there are adverse events because these assets’ carrying values already decline as they are depreciated or amortized

Asset Impairments

- Goodwill and indefinite-lived intangibles are not amortized, so their original cost remains on the balance sheet indefinitely
- As a result, value impairment is of greater concern over time, and Topic 350 requires that impairment possibility be addressed at least annually (more often if there are triggering events)
- Private companies and non-for-profits

Asset Impairments

- Property, plant, and equipment classified as held-for-sale is a special case
- When these assets become classified as held for sale, an impairment loss is required if their carrying values exceed expected net proceeds from the sale ("fair value less costs to sell" or net realizable value)
- These write-downs are the only ones that may not be permanent; recovery in value is allowed to be recorded

Asset Impairments

Impaired long-term assets are carried at fair value

- Assets
- Liabilities
- Business combinations

Asset Impairments

<u>Topic 350 – Intangible Asset Impairments</u>

- Intangibles (goodwill and other) that are considered to have an indefinite life – these assets are not amortized but they must be reviewed for impairment at least annually
- Intangibles that have a definite life – these assets are amortized and are tested for impairment only if a triggering event occurs (similar to impairment of tangible property)

Asset Impairments

<u>Goodwill</u>

- Goodwill is defined 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."
- It results from paying more than the fair value of the identifiable assets and liabilities when acquiring a business.

Asset Impairments

Goodwill

Goodwill impairment analysis is accounted for as follows:

- Evaluate qualitative factors existing at the time of the impairment test that may suggest that it is more-likely-than-not that the goodwill recorded amount on the balance sheet is impaired. If these qualitative factors suggest that the goodwill amount is impaired, then the quantitative impairment test must be performed.
- Quantitative impairment test consists of calculating the implied fair value of goodwill by comparing the fair value of the reporting unit to its carrying value and if the carrying value is greater than its fair value, write down goodwill by the difference – goodwill cannot be reduced below zero.

Asset Impairments

- Goodwill disclosures
- Disclosures – intangibles other than goodwill

Asset Impairments

Examples

Asset Impairments

Topic 360 – Tangible Asset Impairments

The guidance in Topic 360 addresses two separate (but similar) major areas:

1. Assets held and used, although impaired
2. Assets held for sale, which may or may not be connected with discontinued operations

Asset Impairments

Topic 360 – Tangible Asset Impairments – Triggering Events

- Significant decrease in the market value of an asset
- Significant change in the way an asset is to be used
- Significant changes in the business or legal environment
- Significant cost overruns incurred for self-constructed assets
- Continued (or anticipated) operating losses and/or cash flow deficiencies associated with identifiable assets
- A current expectation that it is MLTN the asset will be sold or otherwise disposed of before the end of its useful life

Asset Impairments

Topic 360 – Tangible Asset Impairments

The impairment analysis for property, plant, and equipment is a two-step approach:

1. Determine if impaired
2. Determine amount of impairment loss

Asset Impairments

Required Disclosures for Impaired Assets Held and Used

- A description of the assets impaired and the facts and circumstances leading to the impairment
- The amount of the impairment loss and how fair value was determined along with the caption in the income statement (or statement of activities), which includes the impairment loss, if the loss is not separately disclosed
- How fair value was determined (i.e., Level 1, 2, or 3)
- If the recognized impairment loss is an estimate that has not yet been finalized, that fact and the reasons why and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss.
- The business segments affected, if applicable

Asset Impairments

Example

Asset Held for Sale

Subtopic 360-45-10 addresses assets held for sale which are:

- Segregated from other long-lived assets on the balance sheet
- Carried at the lower of carrying value or fair value less costs to sell
- Not depreciated

Asset Held for Sale

- Management has committed to a plan to sell the asset
- The asset is immediately available for sale in its present condition, subject only to "normal customary" sales terms
- The company has begun an active program to locate a buyer
- The sale is probable and the asset transfer is expected to qualify as a completed sale within one year. There is one exception when there is a firm purchase commitment that may take longer to consummate. In addition, the pronouncement includes a list of circumstances beyond the seller's control that may expand the time to sell beyond one year. In those cases, the company can still classify the asset as held for sale.
- The asset is being actively marketed at a reasonable price
- Significant changes to the sale plan are unlikely

Asset Held for Sale – Disclosures

- The facts and circumstances leading to the expected disposal, the expected manner and disposal date, and the carrying amount of the major classes of assets and liabilities
- The gain or loss, if any, resulting from changes in the carrying amount of the assets and if not shown separately, the caption in the Income Statement or Statement of Activities that includes the gain or loss
- The amount of revenue and pre-tax profit or loss in discontinued operations
- The business segment(s) in which assets to be disposed of are held (if applicable)

Reminders

❑ **Post event evaluation:** Please complete the course evaluation that will be viewable once the session ends. We welcome your feedback!

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