

Differences Between U.S. GAAP and IFRS in Accounting for Goodwill Impairment and Inventory: Tax Treatment Under the Internal Revenue Code

S. Sam Sedki
St. Mary's University

George A. Posada
St. Mary's University

Kimberly A. Pruske
St. Mary's University

This paper examines how to account for goodwill impairment and inventory under the Financial Accounting Standard Board's (FASB) U.S. Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), and the Internal Revenue Code (IRC). Although U.S. GAAP and IFRS accounting standards share some similarities, there are still some key fundamental differences between the two standards. This paper will also detail the treatment of these items by the IRC and how taxation may share some similarities and differences to its financial reporting counterpart.

INTRODUCTION

Over the past decade, accounting professionals from various fields have been working to attain a single set of global accounting standards that will help make business financial statement results uniform worldwide. While financial accounting for certain items are almost identical under both U.S. GAAP and IFRS, other accounting items receive very difference treatment under each standard. In addition to understanding the effects of convergence on financial statement results, accountants must also take the time to contemplate and understand the possible income tax implications that may result from convergence.

GOODWILL IMPAIRMENT

Goodwill Impairment under U.S. GAAP

FASB 141 requires the purchasing company in a business combination to recognize goodwill as of the acquisition date and is measured by the excess of the sum of consideration transferred and the fair value of any non-controlling interest over the fair value of the identifiable assets acquired. Fair value is measured as the amount at which an asset could "be bought or sold in a current transaction between willing parties" (FASB ASC 142, 2001). Goodwill must be tested for impairment at least annually at the

same time every year. Goodwill is not amortized and is tested for impairment after being assigned to reporting units. FASB 142 defines a reporting unit as “an operating segment or one level below an operating segment.” To be assigned to a reporting unit, an asset or liability must relate to the operations for that operating unit and it must be considered when determining the fair value of that unit. The method of determining whether goodwill is impaired under U.S. GAAP principles requires a two-step approach. A recoverability test is first performed at the reporting unit level to determine if the carrying amount of the reporting unit exceeds the reporting unit’s fair value. If so, the second step measures the impairment loss as the implied value of the reporting unit goodwill over the carrying amount of that goodwill. This difference will constitute the impairment loss that is reported, which must be recognized by adjusting the carrying amount of the goodwill. A reversal of this adjustment is prohibited under U.S. GAAP (FASB ASC 142, 2001).

On January 2014, the FASB issued an Accounting Standards Update regarding accounting for goodwill to reduce the cost and complexity associated with the current goodwill impairment requirements (FASB ASU 2014-02). This was in response to the FASB Exposure Draft issued on July 1, 2013 that called for comments on proposed changes in the requirements for testing for impairment and allowing amortization of goodwill. The update allows all entities, other than public and not-for profit- entities, to elect an accounting alternative for the measurement of goodwill. A company can now elect to amortize goodwill on a straight-line basis over a life of up to ten years. After making this election, the entity must test for goodwill impairment at the reporting unit or entity level upon the occurrence of a triggering event. A triggering event is a change in circumstances that indicates the carrying value exceeds the fair value of the entity or reporting unit. An entity then assesses whether it is more likely than not that the carrying value and goodwill exceeds the fair value by evaluating factors that FASB refers to as “qualitative factors” (FASB ASU 2014-02). Among the examples of qualified factors listed under ASC 350-20-35-3C, is “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.” If the assessment indicates that there is a likelihood of impairment, the entity must perform a test to determine if the carrying amount, including goodwill, exceeds the fair value of the entity or reporting unit. This excess will be the impairment loss and it cannot exceed the entity or reporting unit’s carrying amount of goodwill. When an entity makes the election to amortize goodwill and recognizes a goodwill impairment loss, that loss is allocated on a pro rata basis to the goodwill to the amortizable goodwill in each entity or reporting unit. This allocation will create an adjusted carrying amount for the goodwill and is subsequently amortized over the remaining amortization schedule. A reversal of the allocation of impairment loss is prohibited (FASB ASU 2014-02).

There are key differences between current U.S. GAAP and the new election. The most obvious and arguably the most controversial is the option to elect an accounting method that allows an entity to amortize goodwill on a straight-line basis. Other notable differences include U.S. GAAP requiring yearly testing for impairment, while the election provides testing upon a “triggering event,” and eliminating the second step of the current goodwill impairment test under U.S. GAAP (FASB ASU 2014-02). The new accounting alternative can be applied prospectively in annual periods beginning after December 15, 2014. The Financial Accounting Standards Board and the Private Company Council expect that allowing amortization of goodwill will “result in significant cost savings for many private companies...because amortization will reduce the likelihood of impairments and because private companies generally will test goodwill for impairment less frequently” (FASB ASU 2014-02). However, there may be some apprehension with companies adopting the amortization under the new FASB update as professionals may suggest that companies may prefer not to write off goodwill immediately after a business combination (Cohn, 2014).

Goodwill Impairment under IFRS

Unlike U.S. GAAP, IFRS compares carrying amount to recoverable amount. IFRS requires that an entity test for goodwill impairment when there is an “indicator” present in addition to the required annual test (IASB IAS 16). When determining whether indicators are present that may suggest a need for

goodwill impairment testing, an entity should consider a combination of non-exhaustive internal/external factors found in IAS 36 Para. 12 that include: decline in market value, poor performance, and plans to restructure. If there is an indication of impairment, “the recoverable amount should be determined for the individual asset” (IASB IAS 16). IFRS defines recoverable amount as the “the higher of its fair value less costs to sell and its value in use” (IASB IAS 16). If an entity is unable to determine the recoverable amount for the individual asset, then it is determined for the cash-generating unit (CGU). A CGU is defined by IFRS as the “smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets” (IASB IAS 16). The actual test for impairment is conducted by assessing whether CGU’s carrying amount, including goodwill, exceeds the recoverable amount. If there is excess, the entity recognizes an impairment loss equal to that amount. The impairment loss then allocated to reduce the carrying amount of any goodwill allocated to the CGU first, then to other assets in the CGU. If impairment loss is allocated to reduce the carrying amount of other assets in the CGU, it will be done in a pro rata basis. Like U.S. GAAP and the FASB update to goodwill impairment, reversal of goodwill impairment is prohibited under IFRS (IASB IAS 16).

Goodwill Impairment under the Internal Revenue Code

The Internal Revenue Code (IRC) allows a taxpayer to amortize the cost of goodwill as an “amortizable section 197 intangible” asset over a period of fifteen years (26 USC §197a). An amortizable section 197 intangible refers to an intangible that is “held in connection with the conduct of a trade or business or an activity” and includes goodwill (26 USC §197c-d). When the goodwill of an entity becomes impaired, the IRC does not allow a loss to be claimed by that entity, rather when the goodwill becomes “worthless,” the basis of the remaining amortizable section 197 intangibles is adjusted by the amount of impairment loss (26 USC §197f). Therefore, as long as the entity has acquired other amortizable section 197 intangibles that were acquired in the same transaction, there will be no loss recognized in the case of impairment (26 CFR §1.197-2g). Assets that are within the meaning of Section 197 intangible times are going concern value, copyright, patent, franchise, trademark, and license, among others (26 USC §197d). The Treasury Regulations provide guidance on how to properly adjust the remaining intangibles on a pro-rata basis by increasing their basis by the product of the loss not recognized and a fraction, where the fraction “is the adjusted basis of the retained intangible on the date of the disposition over the total adjusted bases of all the retained intangibles on that date” (26 CFR §1.197-2g). The Treasury Regulations also suggest that, in certain circumstances, a loss may be recognized if the intangible was “separately acquired” (26 CFR §1.197-2g). Separately acquired property refers to section 197 intangible property that was not acquired with other section 197 intangibles in the same transaction by the entity, but rather is acquired separately (26 CFR §1.197-2g).

INVENTORY VALUATION

Inventory Valuation under U.S. GAAP

Inventory valuation according to ASC 330-10-30 considers the assets to be initially measured at the cost of acquisition or production. Acquisition costs include “all the costs incurred to bring inventory to a saleable condition and location” (Krishnan & Lin, 2012). Production costs consist of variable and allocated fixed overhead costs. However, any interest expenses incurred in acquiring inventory are not allowed to be capitalized with the costs of inventory. There are four main cost methods used for measuring inventory costs: specific cost; average cost; first-in, first-out (FIFO); or last-in, first-out (LIFO). Companies generally choose the method that most accurately portrays their financial income. ASC 330-10-15 states that a company must adhere to using the same inventory valuation method each year. ASC 330-10-35 describes subsequent valuation of inventory under U.S. GAAP by applying the lower-of-cost-or-market rule. Inventory’s market value is defined as the “replacement cost not exceeding net realizable value and not less than net realizable value minus normal profit” (Krishnan & Lin, 2012). In addition to subsequent assessments of inventory costs, SEC Staff Accounting Bulletin (paragraph 330-10-S99-2) has determined that any written down inventory cannot be reversed, regardless of new facts or

circumstances. Required inventory disclosures are described within Regulation S-X rule 5 (paragraph 210-10-S99-1), under current assets. These inventory disclosures include separately stating any costs allocated to inventory and an explanation of the company's LIFO reserve if using the LIFO valuation method (Krishnan & Lin, 2012).

Inventory Valuation under IFRS

Inventory valuation for IFRS has some similarities to U.S. GAAP, such as valuing initial inventory at the cost of acquisition of production. International Accounting Standard (IAS) 2 provides details on the specific costs that can be included and those that cannot, such as storage and selling costs. However, unlike U.S. GAAP valuation standards, when a company must wait an extended period of time to acquire or make its inventory ready for sale, IAS 23 and IAS 2 state that interest expense may be included within the cost of inventory. Another major difference for IFRS inventory valuation is the disallowance of the LIFO inventory method (Krishnan & Lin, 2012). Subsequent inventory valuation under IFRS differ from U.S. GAAP specifically in regard to the allowance and requirement for companies to reverse any inventory write-downs "when surrounding economic circumstances clearly indicate the net realizable value of the inventory has increased" (Sedki, Smith, & Strickland, 2014). IFRS also differs from U.S. GAAP due to the greater amount of inventory disclosure requirements. IAS 2 specifically describes the required disclosures for inventory, such as "inventory classification; the accounting policy; cost formula used; fair value less costs to sell; inventory expense for the period; write-downs and reversals of write-downs, if any; reasons for reversals; and value of any inventory used as collateral" (Krishnan & Lin, 2012).

Inventory Valuation under the Internal Revenue Code

In addition to the long deliberation on the proposed change from U.S. GAAP to IFRS for financial reporting purposes and its potential consequences, there are also major income tax concerns to be considered, specifically regarding the disallowance of the LIFO inventory valuation method under IFRS. Under 26 USC §471(a), "inventories must be accounted for if such accounting 'is necessary in order clearly to determine the income of any taxpayer'" (Hoffman & McKenzie, 2009). Furthermore, the Internal Revenue code has specified a LIFO conformity requirement within 26 USC §472(a)-(c) which explains that a taxpayer can elect to use LIFO for tax reporting purposes only if it also does so for its financial reporting. As a result of the continuing discussion to converge U.S. GAAP and IFRS accounting standards, taxpayers are concerned as to what the future tax implications will be if LIFO is no longer allowed for tax purposes due to a switch to IFRS.

26 USC §471 permits the United States Treasury Department to determine allowable inventory methods for a trade or business. In 1939, the Treasury exercised this power to allow LIFO as an acceptable inventory valuation method. However, when the Treasury released its "Green Book" to detail Obama's 2010 fiscal year budget, it included a proposal to repeal the use of LIFO because it "provides an unfair tax deferral opportunity for taxpayers holding inventories with costs that increase over time" (Turgeon & Poplock, 2009). However, companies that utilize the LIFO method strongly disagree with the government's perspective. These LIFO-based companies primarily consist of manufacturers and distributors that have slow-moving inventory and are therefore susceptible to rising inventory replacement costs. These companies believe that the use of LIFO is most economically accurate "because it stifles inflationary effects by matching current expenses and current sales more closely than other methods" (Leone, 2010). Other proponent of LIFO, such as Bill Jones, vice chairman of O'Neal Industries, argues that the method "'protects us from having to pay taxes on what are not really profits'" (Leone, 2010).

The most recent development in the possible repeal of LIFO for income tax purposes was included in House of Ways and Means Committee Dave Camp's comprehensive tax reform plan. This draft plan states that LIFO would no longer be allowed beginning in 2015 and that businesses would have to include their LIFO reserve within their taxable income over a four-year period and subject to a 25% tax rate. However, the draft does include one small tax benefit for small businesses, which would only be subject to a 7% tax rate. Nonetheless, the LIFO reserves of businesses are not liquid assets, which means,

“retroactively taxing the reserves will divert operating cash flows away from productive operations” (Godfrey, 2014). Despite the harsh effects that this LIFO repeal could have on taxpayers, the Joint Committee on Taxation predicts that the removal of LIFO for income tax purposes will increase tax revenues by \$79.1 billion by 2023. Other lawmakers in Congress greatly disagree with this proposed abolishment of LIFO because they believe that it unfairly penalizes taxpayers who legally utilized the LIFO method and abided by previous tax laws. U.S. Representative, Mike Thompson, states, “The purpose of comprehensive tax reform should be to create jobs, make things simpler for people and businesses, and get our fiscal house in order. Ending LIFO will have the opposite effect” (Godfrey, 2014).

“Convergence of US GAAP toward IFRS will continue and, over time, differences between US GAAP and IFRS will likely diminish. However, US adaption is still far off. Other issues will likely keep the US from adopting IFRS completely” (Ehoff & Fischer, 2013).

“IFRS inventory rules do not permit the use of LIFO. LIFO, as used in the US, is largely driven by a rather complex set of income tax rules as developed for the US and published as part of the US Internal Revenue Code. As of the year 2013, there is no international LIFO conformity rule” (Whalen, Jones, & Pagach, pp. 7-26).

Table 1, illustrate GAAP valuation of inventory using FIFO lower of cost or market (LCM) and subsequent valuation/adjustments. LCM is applied on an *Individual item-by-item* basis and assumes the inventory replacement cost is based on the current catalogue prices.

**TABLE 1
ITEMS**

	A	B	C	D
Net Realizable Value (Ceiling)*	\$550	\$580	\$1,000	\$1,150
FIFO Inventory Cost	570	550	930	1,060
Replacement Cost (Market)**	560	530	710	1,100
Selling Price (Catalogue Price)	700	740	1,180	1,380
Commissions and Disposal Cost	150	160	180	230
Floor***	410	432	754	874

*Selling price less Commission and Disposal Cost

**Cost to produce and Sell

***Net Realizable Value less 20% Normal Profit on sales

Using the information from Table 1, the final inventory value for all items is \$2,934.

<u>Item</u>	<u>Replacement Cost</u>	<u>NRV (ceiling)</u>	<u>Floor</u>	<u>Designated Market</u>	<u>Original Cost</u>	<u>Final Inventory Value</u>
A	\$ 560	\$ 550	\$410	\$550	\$ 570	550
B	530	580	432	530	550	530
C	710	1,000	754	754	930	754
D	1,100	1, 150	874	1,100	1,060	1, 100
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Totals				\$2,934	\$3,110	\$2,934

The replacement cost allows uniform rate of Gross profit, companies will discard the historical cost principle when the assets producing future utilities declines. When the inventory losses value or future benefit, inventory is written down and a loss is recognized in the period occurred and not in the period the inventory is sold. When the inventory declines in value and the loss is recorded, the net income will decrease. Both GAAP and IFRS requires inventory write-down when the Net Realizable Value (NRV) is lower than cost. Furthermore, IFRS allows reversal of write down, GAAP disallows the reversal. When lower of cost or market costing method used, a valuation “allowance to reduce inventory to lower of cost or market account is created. Two methods to reduce cost to market may be used, the cost of goods sold which conceals the loss in the Cost of Goods Sold account, and the allowance method (Allowance to Reduce Inventory Cost to Market) Credit this allowance account and debit either COGS or a “loss from reducing inventory to LCM” income statement account. You cannot use the LCM method if you use the last-in, first-out inventory method.

Assume the following information from the ledger of xyz corporation:

Ending Inventory at cost	\$ 95,000
Ending Inventory at market	85,000
Cost of goods sold before adjustment to LCM	140,000
Sales revenue	220,000

Cost of Goods Sold Method

Cost of Goods Sold	10,000
Inventory (asset)	10,000

The Income Statement presentation under this method:

Sales Revenue	\$220,000
Cost of Goods Sold after adjustment	<u>150,000</u>
Gross Profit	\$ 70,000

Allowance (loss) Method

Loss Due to Decline of Inventory to Market	10,000
Inventory (asset)	10,000

The Income Statement presentation under this method:

Sales Revenue	\$220,000
Cost of Goods Sold	<u>140,000</u>
Gross Profit	80,000
Loss due to decline of inventory to market	<u>10,000</u>
	<u>\$ 70,000</u>

Balance Sheet Presentation of Inventory using Allowance Method:

Inventory at cost	\$ 95,000
Less: Allowance to reduce inventory to Market	<u>10,000</u>
Inventory at market value	\$ 85,000

For multiple periods the allowance account is adjusted on balance sheet date. Additional adjustments are made to recognize decreases in the market value in the period of the loss.

CONCLUSION

There are several similarities between U.S. GAAP and IFRS when evaluating goodwill impairment and inventory valuation. Some of the recent and proposed changes to the financial accounting treatment of these items may also create consistency regarding the income tax treatment of these items. Even with these similarities, U.S. GAAP is still far from convergence. Nonetheless, the key to a future successful IFRS adoption remains in the hands of various regulatory agencies who must continue to work diligently to strive for the most seamless transition possible. Additionally, accountants in all disciplines, such as audit, tax, corporate management, professors, and students, must continuously educate themselves on the various aspects of IFRS and U.S. GAAP in order to be adequately prepared for when the convergence is finally achieved.

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