

Deciding When and How to Impair Goodwill: The Case of Enervate Inc.

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Abstract

Constituents to the accounting profession recommend that educators teach critical thinking skills, thus improving accounting graduates' abilities to achieve long-term career success. Students in upper division accounting courses possess the basic understanding of accounting principles and are provided new content requiring analysis and evaluation, which makes these courses a good setting for motivating students to develop critical thinking skills. This paper discusses an exercise for upper division accounting courses that provide students the opportunity to examine the challenging concept of goodwill impairment for a parent company with three separate subsidiaries. The suggested exercise requires students to research, properly cite, and apply the impairment standards under both U.S. GAAP and IFRS, to analyze the differences between the two standards, to write a business letter summarizing the findings, and to consider the ethical issues involved in earnings management.

Key Words: Goodwill Impairments, IFRS, ASC, Ethics in Accounting, Subsidiary, Earnings Management

Introduction

Since the mid-1980s, educators, committees, and researchers have called on the academy to better prepare students for a successful career in accounting. Each of these calls has emphasized the need to improve students' abilities to synthesize information and make effective decisions. In other words, these calls have universally encouraged accounting educators to improve our students' critical thinking abilities.

For example, in 1990 the Accounting Education Change Commission recommended that accounting graduates be taught to locate, obtain, and organize information so that they can identify and solve unstructured problems in unfamiliar settings (AECC 1990). More recently the Pathways Commission extensively evaluated both the needs of the profession and the competencies required for accounting graduates to succeed throughout their careers. One of the commission's conclusions was that we need to teach students to exercise professional judgment and problem solving skills (Pathways Commission 2012 and 2015). Similarly, Lawson, Blocher, Brewer, Cokins, Sorensen, Stout, Sundem, Wolcott, and Wouters (2014) lists analytical thinking and problem solving as one of the foundational competencies on which all other accounting and management competencies are founded.

This current focus aligns with the basic premise of Bloom's taxonomy (Bloom, Engelhart, Furst, Hill, and Krathwohl 1956; Anderson and Krathwohl 2001), which encourages educators to push students beyond remembering, understanding, and applying knowledge, the

foundational levels of learning, into higher orders of learning: analyzing, evaluating, and creating. Students traditionally struggle with these last three levels (Howard, Tang, and Austin 2015), requiring greater focus by educators to help them develop these skills, especially if they are to find long-term success in the accounting profession.

While these skills can, and should, be taught in all accounting courses, there are several reasons why advanced financial accounting courses provide an optimal setting for stimulating students to develop these skills. First, students at this level already possess the basic understanding of financial accounting principles and the accounting cycle necessary needed as a foundation for developing higher order thinking skills. Second, topics such as consolidations, leases, pensions, and impairments all provide unique challenges for anyone learning them for the first time. Thus, higher order learning skills, such as analyzing and evaluating will help students genuinely learn and internalize the methods involved. Third, FASB has recently changed the standards for many of these higher level financial accounting topics, thus providing an excellent setting for students to practice both research skills to find and interpret new rules and analyzation tools to compare the new standards with those currently used. Given the need to develop students' critical thinking abilities and the appropriate setting of an advanced financial accounting course, this paper introduces a classroom exercise that can be used in an advanced financial accounting course to help students develop their analytical and critical thinking skills.

Purpose of the Exercise

The Enervate exercise helps students to develop their critical thinking skills in several ways. First, the exercise requires students to find the appropriate rules and methods for impairing goodwill under both U.S. GAAP and IFRS and to provide references to the regulations as part of their answers (a skill our students consistently lack). Despite the thorough descriptions provided in most advanced financial textbooks, students will typically not be able to complete the analysis of goodwill without finding, reading, and synthesizing the actual code.¹ The requirements of the exercise force students to consider additional standards, beyond the primary rules for goodwill impairment, in order to successfully answer the questions. Most students, at least in our experience, tend to stop their research once they have found the first applicable standard. Thus, forcing students to go beyond that first look shows them that a more comprehensive look at the standards is typically necessary to successfully address new accounting issues.

Second, the exercise requires students to compare U.S. GAAP and IFRS standards. Because the solutions under the two standards are similar for two of the subsidiaries being evaluated, but significantly different for the third, the exercise provides an excellent opportunity for students to see how the standards diverge and how the choice of standards can significantly affect a firm's financial statement presentation.² Comparing U. S. GAAP treatment to that under IFRS also provides an additional opportunity for students to develop their analysis and evaluation skills.

Third, the exercise requires students to apply the standards they have identified to the scenarios and determine if any of Enervate's goodwill in its subsidiaries should be impaired during the current reporting period. This process requires students to not only practice the techniques learned in class, but also to use the appropriate standard in making a decision

¹ FASB's ASC database is available to accounting programs at a reduced cost through the AAA and students can register for at ifrs.org/register for free access to the IFRS standards.

² This is true under both the current goodwill impairment standard and the U.S. GAAP standards update (ASU No. 2017-04 becomes effective for publicly traded companies for fiscal year beginning after December 15, 2019).

regarding how a company should proceed in determining goodwill carrying value. Also, the goodwill impairment standards require the use of fair value, which can be subjective. The exercise provides an opportunity for students to understand the subjectivity of fair value numbers and how management could easily manage earnings by small adjustments to fair value estimates.

Fourth, the exercise requires students to write a letter to the CFO of Enervate Inc. describing their calculations and conclusions, encouraging students to synthesize the results from their research and evaluate their positions in a way that will persuade a manager or client to accept their conclusion. As an additional benefit, the letter allows students to practice writing skills, addressing another concern of recruiters and other professional accountants.

Fifth, the exercise requires students to respond to the ethical implications of creating cookie jar reserves. Most ethics cases in financial accounting focus on improving EPS or other ratios. In this scenario, the CFO wants to be more conservative, reporting an even lower net loss. In addition to identifying the issue and those who will potentially be affected by the decision, students are asked to provide a logical, business argument to dissuade the CFO from creating the cookie jar reserves, consistent with the methods introduced in the “Giving Voice to Values” program (Gentile 2010).

While the overarching purpose of the exercise is to help develop students’ critical thinking skills, a secondary goal is to provide instructors with an activity that will develop these skills without requiring significant changes to existing course schedules or placing a significant burden on students. Thus, the exercise typically requires only one day of class discussion, which can be split into two different sessions to further reduce the impact on a course schedule, and approximately three hours of student work time outside of class.

Enervate Exercise

Learning Objectives

The Enervate Inc. Exercise addresses four main objectives, consistent with the purposes described above:

1. Research and properly cite U.S. GAAP and IFRS accounting standards using FASB’s ASC database and IFRS online.
2. Analyze the differences between U.S. GAAP and IFRS.
3. Apply the rules and standards learned in courses or through research to a specific situation and communicate the findings to appropriate parties.
4. Respond to an ethical issue not as common in accounting cases by suggesting the company “take a bath” for the current year instead of working to increase earnings.

Intended Course and Audience

We have successfully used the exercise in a joint undergraduate and graduate advanced financial course at a small land grant institution and also in an undergraduate advanced financial accounting course at a public university. Within those courses, we have run the exercise using the current questions to compare U.S. GAAP and IFRS and have also adapted the exercise to highlight the differences between current U.S. GAAP and the upcoming Accounting Standards Update (ASU) 2017-04, *Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. Instructors can remove IFRS from the exercise by omitting questions 1c, 1d, 2b, and 2e or can reword those questions to require students to compare existing standards with the upcoming update.

In addition to advanced financial accounting, the exercise could be successfully used in a

financial accounting capstone or discussion course or an international accounting topics course. The ethics portion of the exercise could also be used as the basis for an earnings management or ethics discussion in an intermediate course discussing intangible assets, an accounting ethics course, or in an EMBA-style course. When using only the ethics portion of the exercise, we recommend providing the numbers and standards and focusing on questions 2c and 4. In such a course, the instructor would probably have to spend some time discussing goodwill and the nature of cookie jar reserves.

Instructor Notes and Implementation Guidance

Due to the already packed curriculum within accounting courses, this exercise was designed to be a short assignment or class discussion, rather than a comprehensive-style course project. We typically assign the exercise immediately following our in-class discussion of goodwill impairment. During the class sessions before assigning the exercise, we go over at least one example of goodwill impairment and talk about the various concepts involved in the impairment process.³ Before receiving the exercise, our students have also completed, on average, two or three research exercises using the ASC database in their intermediate courses and have used the ASC database in class during earlier discussions in the advanced financial course. Thus, by the time our students receive the exercise they have a basic working knowledge of impairment methods and of the ASC database.

In order to reduce the number of questions we receive outside of class, we typically spend a few minutes discussing our expectations regarding the exercise, with emphasis on the writing and research questions, and answering any questions the students have about goodwill impairment. Since our students are older (senior or masters level), this discussion is typically short (approximately 15 – 20 minutes). At the end of our in-class discussion, we hand out the exercise and the grading rubric for students to reference as they work (the rubric is described in more detail in the grading section).

Once the exercise is assigned, we typically give our students approximately one week to complete the assignment. This short time frame not only fits the length of the exercise, but also ensures that students complete the work before becoming too involved in other topics covered in the course. On average, our students typically spend between three to four hours working on the exercise.

Because the exercise is relatively straightforward, we prefer to have students complete the requirements individually, but it can also be completed in small groups of two or three students. When we do allow students to work in groups, we limit the group work to the first three questions, those focusing on accounting research, calculations, and writing the business letter. The fourth question (the ethics question) is always given to the students individually. This structure allows students to think more carefully and deeply about the ethics scenario, since they know the instructor will be grading their individual work. It also ensures that the instructor can assess the students' writing and ethical problem solving skills on an individual basis to plan future discussions on ethics and to report to accrediting bodies.

Providing Help

Since our students are typically senior or graduate students, we have not had to spend much time outside of class assisting students with the exercise. This is especially true when we allow them to work on the first three questions in groups of two or three, since they are then able

³ A copy of our examples is available from the authors at weissj@uww.edu or jason.porter@wsu.edu.

to discuss their research, calculations, and conclusions. When we do meet with students about the exercise, we do not provide check figures of any kind. However, we will typically let them know if their answers are right or wrong so they can recalculate their solutions if necessary. This limited help for senior or graduate students encourages them to do additional reading or research on their own. As for the ethics portion of the exercise, our discussions with students typically focus on our expectations. Overall, our students tend to be more nervous about “soft answer” questions, such as question four, because there is no right answer. When they ask about what they should write, we typically suggest that they should summarize the conflict described in the exercise and discuss how they feel the conflict should be resolved. The questions in the exercise intentionally avoid asking what the characters “should” do, since most students already know the answer to this question (whether they agree with it or not).

Using the Ethics Portion of the Exercise

After students have completed the exercise we take 15-30 minutes in class to discuss the different ethical issues and whether the exercise poses a realistic problem. We typically structure the discussion as an informal debate with the entire class. To start the conversation, we ask the students about the pros and cons of taking a “big bath” on a goodwill impairment. After a few minutes of discussing the pros and cons, we then ask whether they believe there is any situation where it is appropriate and justifiable to reduce earnings in this way.

After discussing this more general topic, we then focus on this specific scenario by asking the students to discuss what course of action they feel the accounting team should take to ensure that the appropriate level of impairment is recognized (as opposed to writing off all of the goodwill). After allowing the students to brainstorm ideas for a few minutes, we ask whether they think it will be easy to take certain courses of action, using specific examples from the list they have provided. This discussion provides an excellent opportunity to introduce the whistle blowing protection in the Sarbanes-Oxley Act (U.S. Congress 2002) and to discuss how it can apply to those in similar situations to the one described in the exercise.

To wrap up the ethics discussion, we introduce actual examples of goodwill write-offs by corporations. One of the examples that we provide is AOL-Time Warner’s large write-off of goodwill in 2001, one year after the acquisition (Peers and Angqwin 2003). During the first quarter of 2001, the new company wrote-off some of the goodwill from the purchase, ostensibly due to a change in accounting principle. Later in the year, in the fourth quarter, the company wrote-off even more of the goodwill as part of the annual impairment test. Students find the open discussion useful and are usually surprised with the real life example, which demonstrates the complexity of an issue they typically have considered to be straightforward. This discussion has the added benefit in a senior level or graduate class of helping students to understand that accounting treatments are not always as simple as earlier classes and simplified examples may have led them to believe.

Suggested Solutions

The suggested solutions have not been included here to prolong the usability of the case. Instead, the solutions are available upon request from the authors.

Suggestions for Grading

In order to facilitate the grading process, we modified existing rubrics for critical thinking and ethical reasoning (Kraut and Porter 2012), simplifying their five point models to speed up the grading in some areas and expanding some areas to match the exercise requirements. Our

final rubric is shown in Exhibit 1 below. The rubric is designed for use throughout an undergraduate and graduate curriculum, with students demonstrating higher levels of achievement (i.e. Proficient and Accomplished) as they progress from class to class, making it easier to demonstrate overall development throughout students' degree program. Because the rubric was designed for use across the curriculum, our students are already familiar with the basic structure. Since the rubric was designed to cover such a wide range of student abilities, we adjust our expectations when grading this assignment. For example, when using this assignment with juniors, we do not expect them to score in the "Accomplished" section of the rubric, since that range was designed to capture the performance of senior and graduate level students. Instead, we expect our junior level students to score in the "Proficient" section. Thus, the total points possible in a junior level course would be 50 points (the highest level of "Proficient"), the total points in a senior level course would be 66 (the first level of "Accomplished"), and the total points in a graduate course would be 82 (the highest level of "Accomplished"). Overall, we plan for the total points possible to account for approximately 10% of the overall points in our course.

Of the 50 points assigned to the project for a junior level course, we allocate 15 points to questions 1 and 2. Each of these questions are relatively straightforward to grade, since the first asks students to summarize GAAP and IFRS and the second asks students to use the standards to compute the amount of goodwill that Enervate should amortize away. Thus, it is easy to quickly scan students' submissions to ensure that they have correctly answered the questions. We use a grading rubric to speed up the grading process. The Demonstration of Knowledge section of the rubric (as shown in Exhibit 1) is used to assess these first two questions.

We allocate 20 points to question 3, writing the business letter. To help students with this aspect of the assignment, we typically provide specific formatting guidelines and take some time in class to discuss how writing a business letter is different from the essays they were required to write in their general education courses.⁴ Since students can recommend any course of action, we don't base the students' grades on the specific recommendation made. Instead, we break the assessment down into three categories: interpreting and organizing relevant information, reaching an effective conclusion, and effective communication, as shown in the Business Writing section of the rubric.

The final 15 points possible are allocated to the business ethics question, question 4. As with the business letter, we do not look for specific answers when grading this question. Instead, we encourage our students to think broadly in identifying the ethical issues, those affected by those issues, and their arguments to convince the CFO not to engage in unethical behavior.

Overall, it takes approximately 4-5 hours to grade submissions from a class of 20 students using our rubric. Since we do not require our students to score at the top levels of the rubric, students doing exceptionally well can earn extra credit points on some or all of the elements of the exercise.

⁴ If you do not have time or do not want to take time to discuss business writing in class, Chapter 4 of *Skills for Accounting Research*, 3e (Collins and Salzman) is a good source for students.

Exhibit 1**Grading Rubric**

Student: _____ Semester: _____
 Course: _____ Assessed by: _____
 Score: _____

Demonstration of Knowledge (15 points possible)

Component	Developing	Proficient	Accomplished			
Summarizing GAAP, Question 1	<ul style="list-style-type: none"> Does not include important facts, details, or concepts. Incorrectly cites GAAP or cites incorrect sections. 	<ul style="list-style-type: none"> Includes most of the important facts, details, and concepts. Minor errors in information citation 	<ul style="list-style-type: none"> Includes important facts, details, and concepts. Correctly cites GAAP, including all relevant sections. 			
	0	2	4	6	8	10
Calculating Goodwill Impairment, Question 2a & b	<ul style="list-style-type: none"> Used an incorrect process to calculate the necessary values. 	<ul style="list-style-type: none"> Demonstrated a basic understanding of the correct process, but some calculations of the values were incorrect. 	<ul style="list-style-type: none"> Correctly calculated the amount of goodwill to be amortized. 			
	0	2	4	6	8	10
Analyzing Results, Question 2c, d, & e	<ul style="list-style-type: none"> Arrived at an inappropriate conclusion for the scenario. Failed to answer the appropriate question. 	<ul style="list-style-type: none"> Arrived at a conclusion that was partially supported by calculations. Answered some of the question(s), but did not address every aspect. 	<ul style="list-style-type: none"> Arrived at an appropriate conclusion given the facts of the case and calculations. Appropriately addressed all aspects of the question. 			
	0	1	2	3	4	5

Business Writing (20 points possible)

Component	Developing	Proficient	Accomplished			
Interpret and organize relevant information	<ul style="list-style-type: none"> Does not present important points; discusses irrelevant information. Offers data from a biased perspective. 	<ul style="list-style-type: none"> Uses evidence logically to support point of view. Analyzes information from multiple perspectives. 	<ul style="list-style-type: none"> Preserves problem complexity, but emphasizes the most important points. Argues convincingly for own perspective; articulates strengths and weaknesses of position. 			
	0	2	4	6	8	10
Reaches an appropriate conclusion or recommendation	<ul style="list-style-type: none"> Identifies one possible solution or course of action. Does not draw a clear conclusion or make a recommendation. Conclusion or recommendation is not appropriate for the situation. 	<ul style="list-style-type: none"> Clearly explains at least two alternative solutions or courses of action. Draws clear conclusion or makes a solid recommendation. Conclusion or recommendation is not supported. 	<ul style="list-style-type: none"> Clearly explains several alternative solutions or courses of action. Draws a conclusion or makes one or more clear recommendations that are insightful and/or creative. Conclusion or recommendation demonstrates creativity and ability to integrate knowledge. 			
	0	2	4	6	8	10

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Effective communication	<ul style="list-style-type: none"> • Frequent grammatical errors; poor structure, unclear ordering of ideas, and/or misuse of words and concepts. • Writing interferes with the understanding of the content. 	<ul style="list-style-type: none"> • Writing/presentation is relatively clear, flow of ideas is understandable, grammar is essentially correct. • Writing does not interfere with the understanding of the content. 	<ul style="list-style-type: none"> • Well-written; clear flow of ideas; choice of words made paper easy to understand. • Writing enhances the understanding of the content. 		
	0	4	6	8	10

Business Ethics (15 points possible)

Component	Developing	Proficient	Accomplished				
Identifies & summarizes ethical issues	<ul style="list-style-type: none"> • Has a vague idea of what the dilemma is. • Is uncertain about what decision needs to be made. 	<ul style="list-style-type: none"> • Correctly identifies the dilemma, including some pertinent facts. • Identifies, but does not explain, the decision that needs to be made. 	<ul style="list-style-type: none"> • Correctly identifies the dilemma, including most of the pertinent facts. • Clearly explains the decision that needs to be made. 				
	0	2	4	6	8	10	
Considers stakeholders	<ul style="list-style-type: none"> • Is unsure who will be affected by the decision. 	<ul style="list-style-type: none"> • Correctly identifies some of the individuals and groups who will be affected by the decision. 	<ul style="list-style-type: none"> • Correctly identifies the individuals and groups who will be affected by the decision and why they will be affected. 				
	0	1	2	3	4	5	
Recommends an appropriate course of action	<ul style="list-style-type: none"> • Has difficulty identifying an appropriate course of action. • Lacks an objective evaluation of alternatives. 	<ul style="list-style-type: none"> • Suggests a specific course of action. • Shows some effort to objectively evaluate alternatives; weighing of factors is unclear. 	<ul style="list-style-type: none"> • Suggests a specific course of action. • Clarifies values used and trade-offs made in reaching the recommendation. 				
	0	2	4	6	8	10	

Classroom Validation

After completing the exercise, students were asked to participate in an online questionnaire regarding the exercise and its usefulness. Of 186 students who completed the exercise, 82 chose to respond to the optional survey. Among other things, students were asked to evaluate the effectiveness of the exercise in improving their conceptual knowledge of how to test for and impair goodwill, their ability to write a business letter or memo, and their perception of the ethical issues they might face in business. Exhibit 2 summarizes student responses to the survey.

Overall, the student feedback to the exercise was positive.⁵ They felt that the case helped them to understand how to find and use goodwill impairment standards under both U.S. GAAP and IFRS, as shown by the high levels of students choosing Strongly Agree and Agree to survey items 1 – 7. As reflected in survey item 8, 89 percent of students agreed that the exercise provided them with a good opportunity to practice their business writing skills and 92 percent

⁵ Students responded to the survey during the Fall 2011, Spring 2012, Fall 2012, Fall 2017 and Spring 2018 semesters.

agreed that the writing requirement helped them practice making arguments to support accounting standards (survey item 9). Approximately 76-78% of the students found the ethical discussion and write-up helpful (survey items 12 and 13) and 90% agreed that the case helped them think about the types of ethical situations they might face as a professional accountant (survey item 11) and 86 percent felt that the write up helped them consider both sides of the argument (survey item 10). Finally, all but 2 percent of the students felt that the case, overall, was helpful (survey item 14).

Conclusion

The paper provides an exercise for upper division accounting courses that allows students an opportunity to practice critical thinking skills, a recommendation by multiple constituents in the accounting profession. The exercise has four learning objectives: helping students practice their research skills in FASB's ASC database and IFRS standards, analyzing the differences between U.S. GAAP and IFRS, applying the standards and effectively communicating with management, and evaluating an ethical dilemma. Overall, we believe the exercise provides multiple opportunities for students to develop critical thinking skills essential to success in the accounting profession.

Exhibit 2

Summary of Student Feedback

Questions	Strongly Agree	Agree	Neither Agree /Disagree	Disagree	Strongly Disagree
1. Overall, the case increased my understanding of how goodwill is impaired under U.S. GAAP.	55%	40%	5%	0%	0%
2. Overall, the case increased my understanding of how goodwill is impaired under IFRS. ⁶	40%	41%	18%	0%	0%
3. The case helped me to read and understand the ASC sections regarding the impairment of goodwill.	49%	41%	10%	0%	0%
4. The case provided good practice in calculating goodwill impairments.	48%	50%	2%	0%	0%
5. The case helped me to understand how complex the process of impairing goodwill can become.	51%	43%	6%	0%	0%
6. The case increased my understanding of how negative goodwill should be treated.	43%	48%	7%	2%	0%
7. The case provided a good opportunity to practice working with negative goodwill.	49%	39%	11%	1%	0%
8. The business letter required for the case provided me with an opportunity to practice my business writing skills.	40%	49%	9%	0%	2%
9. The business letter required for the case helped me practice making arguments supporting U.S. GAAP.	43%	49%	7%	1%	0%
10. The ethical write-up helped me to think about both sides of the argument between the CFO and the accounting team.	43%	43%	10%	4%	0%
11. The ethical discussion in the case and the write-up helped me to think about the types of situations I might face as a professional accountant and how I will deal with them.	38%	52%	9%	1%	0%
12. The ethical write-up helped me think about the techniques and arguments I could use to encourage ethical behavior in those around me.	27%	51%	18%	4%	0%
13. The in-class discussion about ethics helped me think about how I will act when I face an ethical dilemma.	26%	50%	23%	1%	0%
14. Overall, I felt the case was helpful.	52%	46%	1%	1%	0%

⁶ The IFRS questions were added for the Fall '12 semester

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Appendix A

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Background Information

Enervate Inc. is a publicly held, medium-sized corporation that operates health clubs across the mid-western U.S. Originally, the company's primary revenue stream was derived from gym memberships and class fees, including several lucrative contracts with large companies and universities allowing their employees to participate with no charge to the individual. Since many employees chose not to participate, these contracts brought in a great deal of revenue with little or no cost to Enervate. In recent years, however, many customers have stopped renewing these contracts, forcing Enervate to broaden its horizons to maintain profit margins. Rather than open new gyms or create new membership contracts, the management team decided to use cash reserves to purchase three subsidiaries. These purchases have allowed the company to bring in new revenues without changing Enervate's primary focus on its still-lucrative brand name.

Rather than focus growth in one area, which might lead to another drop in revenues when demand changed, Enervate decided to diversify with its new subsidiaries. The first, MacroMedia Co., is a merchandising firm. MacroMedia has a long history of creating high-quality weights, t-shirts, towels, and other exercise equipment using the logos of various gyms and spas. Despite a strong reputation with clients, bad management by the son of the founder took the company to the edge of bankruptcy, allowing Enervate to purchase 100% interest with little competition.

The second subsidiary, GymDVD Co., directs, produces, and creates exercise videos for gyms across the western U.S. The company has enjoyed relatively strong growth over the past few years, but the management team decided that it would be easier to grow the company as part of Enervate's fast-growing network than to continue trying to raise capital and make contacts on their own. Enervate is now the sole stockholder in the GymDVD.

The third subsidiary, Stepwise Inc., operates small gyms and health clubs in Maine and New Hampshire. Stepwise has been fighting recently to compete with several larger gyms and clubs that have better marketing and cost structures, allowing Stepwise to charge less and pick up more clients. Enervate purchased all of Stepwise's outstanding stock and sent one of its senior managers to take over as CEO. Under this manager's careful guidance, and with help from Enervate's contracts and experience, the company has seen significant growth and is now considered one of the larger gyms in the region.

Like many acquisitions, things went well for Enervate and its three wholly-owned subsidiaries for almost three years. However, economic uncertainty has recently caused many people to cut back on luxuries like gym memberships and specialized equipment. This last year, as memberships expired and other contracts ended, the company was again hit hard, as were all of its subsidiaries. For the first time in almost 30 years, Enervate will be showing a net loss. With political and economic uncertainty still a significant issue for many clients, Enervate's CFO, Steve Empana, has called for a special meeting with the accounting team.

Meeting with the CFO

Papers shuffled as the members of the accounting team settled into their seats and waited for the meeting to start. In addition to Steve Empana, who was busy checking his text messages, the team consisted of the three head accountants for the company. The controller, Deborah Mentique, had been with the firm almost since its beginning. A CPA with several years of experience before joining Enervate, Deborah was nearing retirement and was starting to get tired

of the politics and pressures associated with her job. Next to her, nervously shuffling papers, sat Jim Sampson, one of the assistant controllers and the newest member of the team. Jim had only recently been hired by Enervate. Until six months ago, he had been a senior with one of the Big 4 accounting firms. He had jumped at the chance to leave the hectic schedule of public accounting so that he could spend more time with his family. Now, however, with a fiscal crisis looming, he was worried about his choice and whether he should have stayed with the job he knew.

The other assistant controller, Sally Jacobson, had been with Enervate for about three years. She leaned back in her chair, dreading what was about to come. She had been through meetings like this before in her 20-year career, although not yet with Enervate. Any time management started to worry about the upcoming financial statements, they dragged in the accounting team and asked them to start changing estimates or cutting back on advertising or who knew what, anything that would help to improve EPS by the little bit needed to meet analyst forecasts. She shook her head as Steve finished his last text and looked around at the group. No, she thought as she studied his face, this was not going to be a fun meeting.

“Well,” Steve said in a cheerful voice, “I guess you all know why we are here. Things aren’t looking good for us this year, and I think we need to do something about it.” Gesturing to the financial statements the team had submitted a few days before, Steve continued, “We can’t show our stockholders these numbers. They’d crucify us! And you know what that would do to our bonuses, even if it doesn’t cost us our jobs.”

Sally sighed. Steve didn’t have any accounting background. While a very savvy financier, he had a limited understanding of GAAP, which always made it hard to convince him that he couldn’t just change the numbers to whatever he wanted them to be. She decided, though, to try and reduce the damage. “I don’t think that we really have much choice,” she started. “We can’t change the numbers just because we don’t like them. There isn’t much we can do without violating GAAP and risking problems with the SEC.”

Deborah and Jim nodded in agreement.

Steve sighed. “I was afraid you were going to say that. Well, if there’s no help for it...” he looked around the table, obviously hoping that someone would contradict him. When no one did, he began again. “If there’s no help for it, then I guess we had better start working with the analysts to reduce their expectations.”

Sally was shocked. She had expected Steve to push much harder, to force them to make at least a few changes. Maybe he wasn’t such a bad guy after all.

“Of course,” Steve continued. “We should start thinking about the future.” He paused and looked around and Sally frowned. She should have known better than to raise her hopes. “If we can’t fix this year’s numbers, then we should at least use this year as an opportunity.”

Jim’s brow crinkled. “What do you mean?” he asked.

“I mean,” Steve said, “that since we’re going to have a bad year anyway, we might as well clear out all the damage that we can.” “Clear out damage?” Jim asked. “There isn’t really any damage. We’re just dealing with a weak economy and nervous clients. A lot of other companies are having the same issues, I’m sure. We won’t be the only ones with weak numbers. We’ll take a hit, I’m sure, but it won’t be too bad, and from what I’ve heard of the plans moving forward, we should show solid numbers next year.”

Deborah shook her head. “Jim, Steve is suggesting we write down everything we can during this bad year to make sure that future earnings will be higher. We’ve done it before when our numbers have been weak, although they’ve never been negative before.” She turned to Steve. “It’s probably a good idea. I mean, chances are we’ve been a little optimistic about some of the

numbers over the past few years. For example, we have some inventory that we probably should write down, and perhaps some receivables that we aren't really going to collect, especially now. I can't think of anything else, though."

Jim frowned. "Well, I've heard from some of our staff that some of our gym equipment has been showing more wear and tear than anticipated. Since the machines are wearing out, I think we could legitimately reduce their useful life. Of course, that would raise depreciation expense," he commented.

"Good," said Steve who was actively taking notes. "What about you, Sally, any ideas?"

She thought for a moment then said, "Not really, but I suppose we could impair our loan to Stepwise, since it's unlikely they will be able to repay us any time soon. I think everything else is following GAAP to the letter, and our estimates are already conservative."

Steve smiled. "I'm glad that you brought up the subsidiaries, because I really think that we are showing way too much goodwill on our books." He passed out some numbers he had gathered from the financial statements (see Table 1). "Take a look at these numbers. Don't you think it's inappropriate to be showing over \$300,000 in goodwill for three subsidiaries that are having the same difficulties we are?"

Deborah frowned, "We haven't had any reason to believe the goodwill has dropped in value. However, Steve has a point. With the difficulties we've been having, maybe we do need to impair goodwill."

"Great!" Steve said as if the matter was settled. "We'll just write down the whole \$343,000..."

"Wait a minute," Sally interrupted. "We can't just write down all of it. I mean, I hate to keep bringing up GAAP..." Steve snorted in disagreement, but Sally ignored him. "But I'm pretty sure the rules for goodwill impairment are pretty strict. We'll have to prove to our auditors that a write down is necessary."

"Why?" Steve asked. "As long as we're being conservative, the auditors aren't going to care. Especially if you don't say anything that would make them question the write down."

Deborah jumped in before Steve could keep talking. "We have the financial information for all three subsidiaries right here in these numbers you just gave us. Jim, why don't you dig into GAAP and into the financials of our subsidiaries, then we'll see."

"But..." Steve started to object.

Sally quickly agreed with Deborah. "I think that's a good idea. Let's run the numbers before we make any final decisions. We wouldn't want any more trouble with the auditors, not after last year's mistake in recognizing membership revenues too early. Remember how frustrated the partner was? I don't think she'd hesitate to report any new errors to the Board."

Steve's argument stuck in his throat. "The Board... Hmmm. Well, we wouldn't want them to get upset again over another silly mistake, would we? Let's check the rules and run the numbers. How soon do you think you can get back to me?"

Deborah looked at her staff. "Two days?" Sally and Jim nodded. "Sally and I will get to work on writing down inventory and receivables, and Jim will do the research on the goodwill impairment. We should have numbers ready to show you by Thursday."

Sally shook her head as the meeting broke up. She'd been right. They'd been asked to change the numbers, even though the accounting team felt that they had appropriately followed U.S. GAAP. She wasn't surprised, of course, she'd been asked to do this many times in the past, and she was sure she would be asked to do it many times in the future. At least this time the adjustments were *mostly* legitimate. After all, inventory was a bit old, and the equipment was a

bit worn. She didn't think there was any reason to consider an adjustment to goodwill, but she could live with these adjustments. Couldn't she?

Table 1: Summary of Carrying Values and Fair Values

	Enervate Inc.		MacroMedia Co.	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Total Estimated Fair Value:		\$406,035,100		\$4,919,250
Accounts				
Inventory	\$102,465,320	\$102,465,320	\$3,503,540	\$3,502,140
Customer List	51,358,970	51,358,970	287,435	267,435
Land	121,897,650	121,897,650	20,652	20,652
Copyrights	2,345,000	2,345,000	247,562	247,526
Trademark	74,895,240	74,895,240	10,260	1,750
Equipment (net)	89,456,780	89,456,780	3,289,550	3,289,050
Goodwill	343,769	?	19,500	?
Liabilities	(38,745,620)	(38,745,620)	(2,356,050)	(2,396,050)
	GymDVD Co.		Stepwise Inc.	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Total Estimated Fair Value:		\$1,410,310		\$3,789,425
Accounts				
Inventory	\$589,640	\$579,400	\$1,650,213	\$1,561,213
Customer List	648,902	639,801	452,132	403,132
Land	205,890	236,540	73,645	73,645
Copyrights	14,520	6,654	1,045,872	1,035,870
Trademark	19,720	17,500	415,328	395,320
Equipment (net)	150,350	146,258	256,421	255,421
Goodwill	8,621	?	315,648	?
Liabilities	(228,546)	(228,546)	(234,500)	(234,501)

Requirements

1. Accounting for goodwill:
 - a. In one paragraph, describe the qualitative assessment process required under U.S. GAAP for impairing goodwill. You should summarize, not quote, GAAP and should include proper citations to the Codification. Your description should include when it is appropriate for a company, such as Enervate, to apply the qualitative assessment to avoid the quantitative tests for impairing goodwill. Based on the scenario, do you believe that Enervate needs to do a quantitative assessment for its subsidiaries?

- b. In one paragraph, describe the quantitative process required under U.S. GAAP for impairing goodwill. You should summarize, not quote, GAAP but should include proper citations to the Codification.
 - c. Assume that Enervate is an international company instead of a U.S. company. In one paragraph, describe the qualitative and quantitative process required under IFRS for impairing goodwill. You should summarize, not quote, the IFRS standards and include proper citations. In addition to your descriptions, briefly summarize any significant differences between the U.S. GAAP and IFRS processes.
 - d. Testing for goodwill impairment requires an understanding of what determines a reporting unit for U.S. GAAP and a cash-generating unit for IFRS. In one paragraph, briefly summarize how the difference between a reporting unit and a cash-generating unit could impact the quantitative process for impairing goodwill under both methods. You should summarize, not quote, the Codification and the IFRS standards and should include proper citations to both.
2. Determining the amount of goodwill impairment:
 - a. Assuming that Enervate does not meet the qualitative assessment criteria to avoid the quantitative test and must, therefore, do the quantitative tests, use the U.S. GAAP process you identified in Part 1b to determine how much, if any, goodwill impairment Enervate should recognize for each of its subsidiaries.
 - b. Using the IFRS process you identified in Part 1c, determine how much, if any, goodwill impairment Enervate should recognize for each of its subsidiaries? In addition to your calculations, briefly describe the assumptions that must be made under IFRS in order to complete this test, given the information provided.
 - c. Do the goodwill impairment standards allow for an earnings management opportunity, as Steve suggested? Specifically, do any of the requirements for goodwill impairment allow for earnings management?
 - d. Do you think Steve will be pleased with your answers to Parts 2a and 2b? Which process, U.S. GAAP or IFRS, do you believe Steve would prefer?
 - e. If Steve wants to use the IFRS amounts instead of the U.S. GAAP amounts, what other issues would the company face?
 3. Write a formal memo to Steve summarizing your recommendation for writing down, or not writing down, goodwill. Your memo should be as convincing as possible to avoid further arguments.
 4. Read through the scenario and consider the following questions about ethics. As you do, keep in mind that ethical analysis and reasoning are important parts of the AICPA and IMA standards and play an important role throughout the accounting profession.
 - a. What ethical issues do you see?
 - b. Who is likely to be affected by the ethical issues you have identified? Think outside the box and list as many as possible.
 - c. Assume that Steve still wants to write down all of the goodwill to increase this year's net loss and, thereby, improve future earnings, especially by comparison. What argument could Sally use to ensure Enervate's financial statements for the current year follow the appropriate accounting standards? Provide at least three (3) business arguments against this method of manipulating earnings.