

Accounting for Asset Impairments Under GAAP

Asset impairment can be one of the trickier areas of GAAP to navigate, with different rules applying depending on the type of asset involved. This section breaks down the authoritative guidance behind impairment testing and accounting treatment by asset category, making it easier to apply the right approach in practice. If you work with clients or employers who hold long-lived assets, intangibles, or other impairment-sensitive items, this course offers clear, practical guidance you can put to use right away.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the types of information that should be used in computing the allowance account for trade receivables.
- Recognize how FIFO inventory is valued under the inventory rules.
- Recall certain inventoriable costs.
- Recall the GAAP rules to account for an intangible asset with a finite useful life.

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Section 1

Chapter Objective

After completing this section, you should be able to:

- Recognize the types of information that should be used in computing the allowance account for trade receivables.
- Recognize how FIFO inventory is valued under the inventory rules.
- Recall certain inventoriable costs.
- Recall the GAAP rules to account for an intangible asset with a finite useful life.

D. RECEIVABLES

1. Installment receivables

Question: Should installment receivables be presented as current assets?

Response: ASC 210-10, *Balance Sheet- Overall*, states that the term “current assets” includes installment or deferred accounts and notes receivable *“if they conform generally to normal trade practices and terms within the business.”*

As a result, the entire installment receivable should be presented as a current asset if it is a normal trade practice within the industry to do so. Absent a normal trade practice, the author believes an installment receivable should be split so that the portion of the receivable to be received within the current year (or operating cycle) would be presented as a current asset while the remainder shown as a non-current asset.

2. Accrued Interest on Past-Due Receivables

Question: When should a lender stop accruing interest revenue on past-due receivables?

Response: There is no authoritative guidance in this area. In practice, many banks stop accruing interest when loan payments stop. It is most likely prudent to stop accruing interest on any account for which an allowance has been established based on the premise that it is unrealistic to recognize income which probably will not be collected.

3. Allowance for Credit Losses

Question: In computing an allowance for credit losses on trade receivables, is an entity permitted to use information after the balance sheet date, such as anticipated changes in the economy and other forecast information that affects the collectibility of the receivables?

Response: Prior to 2023, the computation of the allowance for uncollectible accounts (the name used at that time) was based on the incurred loss model. More specifically, the incurred loss model was based on the contingency rules found in ASC 450, Contingencies.

ASC 450 states that there should be an accrual for a loss if both of the following conditions are met:

- a. Information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired at the balance sheet date, and
- b. The amount of loss can be reasonably estimated.

In practice, the contingency rules in ASC 450 are better known as the “probable and estimable requirement.”

For years prior to 2023, GAAP’s incurred loss model required an entity to compute an allowance account on trade receivables if the two requirements in ASC 450 were met. That is, at the balance sheet date, it was probable that the receivable was impaired (the trade receivable was uncollectible) and the amount of the loss could be reasonably estimated.

The incurred loss model prior to 2023 precluded an entity from using economic conditions and forecasted information to compute the allowance account. Simply put, unless at the balance sheet date, it was probable that a trade receivable was impaired (uncollectible) and the amount of loss was reasonably estimated, no allowance could be set up.

That all changed in 2023 with the issuance of ASU 2016-13.

Starting in 2023, ASU 2016-13, *Financial Instruments- Credit Losses (Topic 326, Measurement of Credit Losses on Financial Instruments)*, becomes effective and introduces new ASC 326.

ASU 2016-13 does the following:

1. It replaces the previous incurred loss model for recording an allowance, with the new expected credit loss model.
2. The expected credit loss model requires that the allowance for credit losses (uncollectible accounts) should be measured based on broader relevant information using:
 - Past events, including historical experience,
 - Current conditions, and
 - Reasonable and supportable forecasts that affect the collectibility of the reported amount.

The expected credit loss model has, as its goal, the determination of how much of the trade receivable the entity expects to collect in the future. Any shortfall in the amount expected to be collected is recorded as an allowance for credit losses (the new allowance name under the ASU).

In determining the amount of a trade receivable an entity expects to collect, the entity uses not only historical information, but also current economic and other conditions, and reasonable and supportable forecast (future) information.

The expected credit loss model is a dramatic change from the previous incurred loss model because the amount of allowance for credit losses that an entity records is not limited to potential uncollectible accounts that exist at the balance sheet date. Instead, an entity may record an allowance for a portion of its trade receivables that are current with no indication whatsoever that those receivables are uncollectible at the balance sheet date. The assumption is that a portion of “good” receivables might become uncollectible in the future and will reduce the amount the entity expects to ultimately collect.

Note further that under the new expected credit loss model, the terminology has changed.

- a. Allowance for uncollectibles or bad debts has been replaced with “*allowance for credit losses*,” and
- b. Bad debt or uncollectible expense is replaced with “*credit loss expense*.”

Question: What if, under the new ASU 2016-13 expected credit loss model, an entity concludes that no allowance for credit losses should be recorded?

Response: There may be instances in which an entity uses the new expected credit loss model and concludes that it expects to collect 100 percent of the trade receivables outstanding, and that zero allowance for credit losses is required.

ASC 326-20-30-10 addresses this issue and states that that an entity is not required to measure expected credit losses (measure an allowance for credit losses) in situations in which:

“historical credit loss information adjusted for current conditions and reasonable and *supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero.*”

Therefore, in such instances, no allowance for credit losses is recorded because an entity expects to collect all of the trade receivables.

Question: Under the new ASU 2016-13, is an entity required to present the allowance for credit losses separately on the balance sheet?

Response: ASC 210-10-45-13, Balance Sheet, states that “asset valuation allowances for losses, such as those on receivables and investments, shall be deducted from the assets or groups of assets to which the allowances relate.”

ASC 326-20-45-1 further states that an entity shall “*separately present on the statement of financial position, the allowance for credit losses that is deducted from the asset’s amortized cost basis.*”

That means:

- a. An entity should either separately disclose the amount of allowance parenthetically on the balance sheet or show the amount on a separate line item on the balance sheet.
- b. Presenting a net accounts receivable balance on the balance sheet without separately presenting the allowance amount either parenthetically or as a separate line items is not acceptable.

Consider the following two ways to disclose the allowance on the balance sheet:

Option 1: Present it parenthetically on the balance sheet

XYZ Company	
Balance Sheet	
December 31, 20X1	
<u>ASSETS</u>	
<u>Current assets</u>	
Cash	XX
Accounts receivable (net of allowance for credit losses of \$XX)	XX
Inventories	XX

Option 2: Present it separately on the balance sheet

XYZ Company	
Balance Sheet	
December 31, 20X1	
<u>ASSETS</u>	
<u>Current assets</u>	
Cash	XX
Accounts receivable	
Gross amount	\$XX
Allowance for credit losses	(XX)
	XX
Inventories	XX

Question: Is an entity permitted to use the direct write-off method for GAAP in lieu of using the expected credit loss model and allowance account?

Response: No. Although the direct write-off method is used for tax purposes, GAAP does not permit it. If an entity were to use the direct write-off method for GAAP, it would be a GAAP departure.

E. INVENTORIES

1. Lower of Cost and Net Realizable Value Method

Question: How should an entity value its inventories under the new valuation rules?

Response: ASU 2015-11: *Inventory (Topic 330) – Simplifying the Measurement of Inventory* dramatically changes the way in which entities value their FIFO and average cost inventories.

A summary of the key provisions of the ASU follows:

- a. The ASU applies to all inventory valuation methods other than LIFO and retail inventory method which means it applies to FIFO and average cost inventories.
- b. The ASU makes no changes to inventory measured using LIFO or the retail inventory method so that lower of cost or market continues to be used for the LIFO and retail methods.

Note

For LIFO and retail methods using lower of cost or market, the term “market” continues to be defined as replacement cost, subject to a ceiling and a floor.

- c. Under the new rules, an entity should measure inventory measured on FIFO or average cost at the lower of cost and net realizable value as follows:¹⁰

Net realizable value:

Estimated selling prices in the ordinary course of business	\$XX
Less reasonably predictable costs of completion, disposal (sale), and transportation	(XX)
= NET REALIZABLE VALUE	\$XX

- d. Lower of cost or market is no longer used for FIFO or average cost.

Note

For FIFO and average cost inventory, use of replacement cost, with a ceiling and floor, is eliminated, and replaced with one outcome which is net realizable value.

- e. Net realizable value (NRV) is defined as estimated selling price less costs of completion, disposal and transportation.
- f. Once written down to either lower of cost and net realizable value or lower of cost or market, the written down amount becomes the new cost:
 - The write-down cannot be reversed under U.S. GAAP.
- g. ASU 2015-11 provides that the lower of cost and net realizable value may be applied either:
 - Directly to each individual item
 - To the total inventory, or
 - To the total of the components of each major category.

2. Uniform Capitalization (UNICAP) Rules - GAAP

Question: Do the additional 263A costs capitalized for tax purposes in accordance with section 263A of the IRC constitute inventoriable costs for GAAP?

Response: ASC Subtopic 330-10, *Inventory- Overall*, addressed this issue as follows:

*“The fact that a cost is inventoried for tax purposes does not, in itself, indicate that it is preferable, or even appropriate, to inventory that cost for financial statement purposes. Certain of the additional costs that are required to be capitalized for tax purposes may also be capitalized for financial reporting purposes***, depending on such factors as the nature of the enterprise’s operations and industry practices. The determination, however, can only be made after an analysis of the individual facts and circumstances.”*

In essence, the FASB’s comments appear somewhat ambiguous, providing little guidance on the matter. To provide more specific guidance, one must review the definition of inventory costs found in ASC 330-10-30, which states:

“As applied to inventories, cost means....the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. It is understood to mean acquisition and production cost...”

Under most circumstances, general and administrative expenses shall be included as period charges, except for the portion of such expenses that may be clearly related to production and thus constitute a part of inventory costs (production charges). Selling costs constitute no part of inventory costs... ”