Usingthe*Codification*toResearchaComplexAccountingIssue:TheCaseofGoodwillImpairmentatJacksonEnterprises

ABSTRACT:ThiscaseisdesignedtohelpstudentsdevelopresearchskillsusingtheFinancialAccountingStandardsBoard’s(FASB)*AccountingStandardsCodification*(*Codification*orASC).Thecasealsohelpsdevelopstudents’abilitiestoanalyzeandrecommendalternativesforacomplexaccountingissue,goodwillimpairment,whichisveryrelevantintoday’sbusinessworld.Thiscasecanbeusedinanundergraduateorgraduateaccountingclass,eitheringroupsofstudentsorasanindividualstudentproject.

Keywords: FASB*Codiﬁcation;*goodwillimpairment.

CASE

GoodwillImpairment—BackgroundSummary

herequirementsforassessingthevaluationofgoodwillsubsequenttoacquisitionhavesignificantlychangedoverthepast15years,mostrecentlywiththeoptiontoperformqualitativeassessmentspriortothecommencementofthetwo-stepimpairmenttestandtheamortization alternativenowavailableforprivatecompanies. Furthermore, thevaluationofgoodwillrequiressignificantjudgment,andthustheauthoritativeliteratureisaccompaniedbysignificantimplementationguidance.Thestandardssurroundinggoodwillandthefollowingcaseprovidestudentstheopportunityto(1)obtainafurtherunderstandingoftherelatedconceptslearned fromtextbooks,(2)sharpentheir professionalresearchskills,and(3)applyjudgmentina

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relevantscenario.

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CompanyOverview—JacksonEnterprises

JacksonEnterprises(JE),apubliclytradedcompany,producesandsellsproductsinseveralsectorsoftheU.S.economy.OneofJE’smajorsegments,whichmeetstheFinancialAccountingStandardsBoard(FASB)definitionofanoperatingsegment,isitssemiconductorbusinesscomprisedoftwosubsidiarycompanies:DynamicTechnologies(80percentownedandpubliclytraded),andZDSystems(whollyowned).DynamicTechnologies(hereafter,Dynamic)isheadquarteredinthenortheasternsectionoftheU.S.andspecializesinthemanufactureofelectronicsensorsandindicatorsusedonautomatedproductionsystemsinNorthAmerica,Europe,andAsia.In2011,JEacquired80percentofDynamic’scommonstock,atransactionresultingin

$150millionofrecognizedgoodwill.ZDSystems(hereafter,ZD),acompanyheadquarteredinthemid-westernsectionoftheU.S.,manufacturessensor-typedevicesusedsolelyforagriculturalmachinesandsystemsintheU.S.AtthetimeoftheacquisitionofZDinearly2006,JErecorded

$50millionofgoodwill.Whilethetwosubsidiariesareclassifiedwithinthesamesegmentforsegmentreportingpurposes,theyaredistinctentitiesandhavenointercompanytransactions.

Industry Information—Dynamic

TheproductionoftheelectronicsensorsandindicatorssoldbyDynamicanditscompetitorsoccursinahighlystructured,semi-automatedenvironment.Accordingly,theindustryhasestablishedconsistentguidelinesandbestpracticesastheyrelatetomanufacturing.Consistentwiththishighlevelofautomation,alargelaborunionactivelyrepresentstheemployeesofalmosteverycompanyintheindustrythroughacollectivebargainingprocess.Recently,theindustryexperiencedaninfluxoftechnologicaladvancementstoitsstandardmanufacturingprocess.Suchinnovationsallowthecompaniestobettertrackrawmaterialsthroughouteveryproductionrun,ultimatelyreducingthewastenormallypresentinthemanufacturingprocess.Thetechnologyiseasilyaccessibletoexistingandpotentialindustryparticipants;asaresult,thenumberofcompetitorsincreasedby35percentinthepastyear.

Whilethosewithintheindustryviewthenewmanufacturingadvancementspositively,therelatedpracticesusedbythecompanieshavefacedscrutinyrecentlyduetotheirextensiveenvironmentalandworkplaceimpacts.Theaveragemanufacturingplantintheindustryemitscarbonathigherratesthansomeautomobilemanufacturers.Asaresult,manycompanieshavebeensubjecttothecloseeyeoffederalandstateenvironmentalagencies.BothregulatorsandunionrepresentativeshaveclaimedthatpollutionposeshealthhazardstoDynamic’sworkforce.

Organizational Information—Dynamic

Dynamic’sstrategicinitiativesbeginwiththesevenexecutivesmakingupitsseniormanagementteam.Overall,thecompanyemploysapproximately1,500employees,102ofwhichstafftheaccountingdepartment.Recently,theemployeesofDynamicsuccessfullysecuredacollectivebargainingagreementwiththebackingofthemajorunionwithintheindustry.Theagreementbecomeseffectiveinthefirstquarterofcalendar2015.

Dynamic’sproductionprocessforsensorsandindicatorsfitsthestandardsandbestpracticesoftheindustry.Thecompanyusesamostlyautomatedassemblyline,whichisstaffedbyanumberofmachineoperators,qualitycontroltechnicians,andsupervisors.Theseemployeesreceiveextensivetrainingthroughindustryworkshops,aswellasindustrytrainingbooklets.Theproductiondepartmentperformstwodailyproductionrunssixdaysaweekfor50weeksduringeachyear.Dynamichasbeenabletokeepmaterialcostslowrelativetoitscompetitorsduetosomenegotiatedshort-termpurchasecommitmentswithsuppliersinthepastthreeyears.Duringthecurrentyear,thetypicalcostofproducingasensorwasapproximately$800,andthecompanyconsistentlyappliesa

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25percentmarkuponcostinestablishingthesalesprice.Dynamicsellsitsfinishedsensorsandindicatorsthroughanumberofdomesticandinternationaldistributors.Thedomesticdistributorsalsoengageinthedistributionofreplacementpartsforcomputersandhigh-endmedicalequipment.Toaddressthegovernmentagencies’recentscrutinyregardingindustrypracticespertainingtoenvironment and workplaceissues, Dynamic’s manufacturing personnel recently developed planstoinstitutecomplianceandreportingsystemswithinthemanufacturingdepartment.Thesysteminvolvestheadditionofemployeeswhomwilladministerself-auditsofthecompany’semissions,investigateworkingconditions,anddesignpracticestobettertrackthecompany’scarbonemissionsandactivitiesaimedatenhancingworkplacesafety.Noothercompaniesintheindustryhavecreated suchamonitoringmechanism. Dynamic’s managementfeelsthatsuchasystemisnecessaryaspartofitslong-termobjectivesinordertorespondtorecentandfutureincreasesin

regulatoryactivity.

DynamichasexperiencedstablegrowthandprofitabilitysinceitsacquisitionbyJE.In2014,thecompany’sgrossmarginheldsteadyatapproximately20percent,threepercentagepointsabovetheindustryaveragefortheyear.InAugust2014,JEexecutivesorderedappraisalsofallofitsholdingsaspartofastrategicmanagementinitiative.TheindependentappraisalcompanyvaluedDynamic’sbusinessat$830million,baseduponearningsmultiplesderivedinconjunctionwithanalysisofothercompanieswithinDynamic’sindustry.AsofDecember31,2014,Dynamichad30,000,000sharesofcommonstockissuedandoutstanding.ThepersharepriceofDynamic’scommonstockgraduallydecreasedduring2014from$27/shareonJanuary1,2014to$23/shareonDecember31,2014.Acondensedsummaryofbalancesheetinformation(inmillions)forDynamicasofDecember31,2014ispresentedbelow.

DynamicTechnologies

CurrentAssets $2,555

Non-CurrentAssets(includingGoodwill) $3,714

CurrentLiabilities $2,161

Non-Current Liabilities $3,335

Industry Information—ZD

ZDoperatesinalooselyorganizedindustrythatincludesonlyafewcompetitors.Eachcompany’sproductcontainstechnologydistinctlydifferentfromthatofthecompetitionandthusasignificantamountofvariabilityexists betweenthemanufacturingprocessesofcompetitorsintheindustry.Asaresult,thecompaniesshareverylittleinformation.Differenceswithintheindustry,including theuniquenessof thetechnologiesemployed,havemadeit virtually impossiblefor newpotentialcompetitorstocarveanichewithinthisindustrysector.Infact,inthepastsixyears,thenumberofcompetitorshasremainedconstant.Becauseoftherolethisindustryplaysinenhancingagriculturalinnovationandcultivation,federalandstategovernmentleadershavetakenaninterestincreatingabusiness-friendlyatmosphereforcompaniesinthisindustrycommittedtoenhancingthecompetitiveadvantageofournation’sfarmersandranchers.

Organizational Information—ZD

ZDisconsideredamongcustomersandotherindustryparticipantsasthedriverofagriculturalinnovation,beingtheforemost competitorintheindustry.BecauseofZD’sestablishedreputation,thecompany’smarketshareisdominantinthisindustry.JE’sexecutivesconsiderZDasoneofitsbestenterprises.ZDstandsapartfromitscompetitorsbecauseofthestate-of-the-artmanufacturingprocessmanagementdevelopedoverthecourseofseveralyears.Theproductionsystemforthesensordevicesinvolvesspecializedwelding,fusing,assembly,andqualitycontrol.ZDmanagers

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haveworkeddiligentlytodevelopapatentforthecompany’suniquemanufacturingprocessandmethodology.AsofDecember31,2014,thepatentapplicationwaspendingapproval,butmanagementremainsoptimistictheapplicationwillultimatelybeapprovedbytheUnitedStatesPatentOffice.

Inaddition,duringthepasttwoyears,companyscientistsadvancedsometechnologyandcreatedprotocolssubstantiallyreducingtheusageofpreciousmetalsandhazardousmaterials,allowingproductionoperatorstocompletetheweldingandfusing ofthematerialsatless-extrememachinetemperatures.Asaresult,thecompanyhasreduceditsutilitycostsby15percenteachyearforthepasttwoyears,pushingthecompany’sgrossprofitmarginto35percent.Duetotheseutilitycostimprovements,ZDrecentlybecameeligibleforastate-administeredmanufacturerenergysavingsincentivesubsidy.Thisimprovementinenergyefficiencyalsocaughttheeyeofenvironmentalandsustainablebusinessorganizations,andthecompanyrecentlywonanindustryawardforitssustainablebusinesspractices.

Thecompanyproducesonebatchofsensorseachweekdayduring46weeksofthecalendaryear.During2014,theaveragecostofonesensorwas$1,495markedupby53.85percent1inthemarket.ZD runs anin-housedistributionsystem, workingdirectlywith agriculturalcompanies,aswellasafewsizablefarms/ranchestofillcustomerorders.

ZDemploys1,200individuals,including12membersinexecutivemanagementpositions.Theaccountingandfinancedepartmentisstaffedwith86employees.Ingeneral,managementmaintainsaverygoodrelationshipwithmostofitsindividualemployees,severalofwhomspeakveryhighlyofthefamily-likeatmospheresurroundingthecompany’soperations.Asaresult,employeeturnoverisminimalatZD.

DuringtheroundofAugust2014independentappraisals,ZDwasvaluedat$1.1billion,afigurederivedby using thesamevaluationmethodology appliedtoJE’sother subsidiaries,includingDynamic.Acondensedsummaryofbalancesheetinformation(inmillions)forZDasofDecember31,2014ispresentedbelow.

ZDSystems

CurrentAssets $3,000

Non-CurrentAssets(includingGoodwill) $1,346

CurrentLiabilities $1,456

Non-Current Liabilities $1,960

CaseRequirements

FinancialreportingpersonnelatJEareintheprocessofcompletingyear-endactivities,includingnecessaryadjustingentriestotheconsolidatedfinancialstatements.WhileJEhasnotpreviouslybelieveditnecessarytoadjustitsrecognizedgoodwillfromtheDynamicandZDacquisitions, thevaluationofgoodwillis,nonetheless,aprominentconcernintheclosing process.AssumeyouareaskedtoresearchthefinancialstatementissuessurroundingthegoodwillrecordedfortheDynamicandZDsubsidiaries.Pleaserespondtothefollowingquestions/statements.Donotciteyourcoursetextbookoranyothertextbook,astextbooksarenotauthoritativeguidancewithregardstoaccountingresearch.Youshouldturninyouranswerstoalloftherequirementsbelow.

1. Identifyand citethe relevanttopics/subtopics from theFASB Accounting*StandardsCodification* forthiscase.

1 Averagecostis$1,495;times1.5385equalsasellingpriceof$2,300.The$2,300unitsellingpriceless$1,495-unitcostequalsagrossmarginof$805,whichis35percentofsellingprice.

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1. IdentifythespecificaccountingissuethatyoubelieveneedstobeinitiallyaddressedforJE’sconsiderationofgoodwillwithregardstobothDynamicandZD.
2. WhatdoesthequalitativeevidencefromthecaseindicateaboutwhetherJEshouldperformthetwo-stepimpairmenttest?Inyourresponse,identifyspecificfactorsdiscussedinthe*Codification*andrelatethemtotheinformationprovidedtoyouinthecase.
3. Beyondtheassessmentofqualitativefactors,whatotherevidenceshouldbeconsideredforthepurposesoftheanalysis?Whatdoesthisinformationsuggest?WithrespecttoDynamic,whatdoyouthinkisthemostappropriatefairvalueamounttouseinassessingthefairvalueofthisreportingunit?Explain.Whyisthisimportant?
4. Basedupontheinformationprovidedabove,shouldDynamicandZDbecombinedorseparatedforthepurposesofthegoodwillanalysis?Explain.Whyisthisimportant?
5. Baseduponyourinitialanalysis,doyouthinkthe$200milliongoodwillbalance(i.e.,the

$150millionforDynamicandthe$50millionforZD)istheappropriatevaluationforgoodwillontheDecember31,2014balancesheetofJE?

1. Prepareamemodetailingtheissuesinvolved,thejudgmentsyoumadeinconnectionwiththeauthoritativeliterature,andyourrecommendationforthedirectionofthegoodwillvaluationasitrelatestoDynamicandZD(i.e.,doestheevidencesuggestfurtheractionisrequired indeterminingthe appropriatevaluationof goodwill? Ifso, whatstepsneed tobetaken?)