

# TS Insights

## Financial reporting in an uncertain economy

### Determining when, what, and how much to impair a long-lived asset

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*Volatile financial markets and a global economic slowdown can trigger a broad range of financial reporting issues. These and other recent indicators such as ongoing and forecasted operating losses and downsizing efforts have been leading many companies to focus on asset values and whether there might be associated impairment charges. As a result, many are going beyond their annual testing for goodwill impairment to undertake processes they may not have needed during historic periods of growth and stability, such as testing long-lived assets for impairment. For some, the new processes can be particularly subjective and challenging to apply in practice. Understanding what to expect and thinking about how to address the accounting and valuation issues will enable companies to plan ahead and potentially avoid costly, last-minute surprises.*

The market reaction or lack thereof to impairment announcements varies by company, and determining the impairment charge to take on an asset is often not straightforward. Most of the focus on impairments has centered on debt and equity investments and goodwill. However, given the current market conditions, many companies also face potential impairments on their long-lived assets (for example, machinery and equipment and finite-lived intangibles). This paper focuses on accounting and valuation matters that may need to be considered when testing long-lived assets for impairment.

#### A recap of the test

Unlike the annual goodwill impairment test, the impairment test for finite-lived assets is performed on an exception basis when there is reason to suspect that the carrying amount of a long-lived asset may not be recoverable. For example, changes in market conditions may cause significant adverse effects in specific operations, warranting a review of the long-lived assets supporting those operations.

The impairment test for finite-lived assets comprises two steps. The first step compares the sum of the *undiscounted* cash flows associated with an asset or group of assets (hereinafter "asset group") to the carrying amount of the asset group. If the undiscounted cash flows (i.e., the recoverable amount) exceed the carrying amount, no impairment is taken, even if fair value is less

than the carrying amount. If the recoverable amount is less than the carrying amount, a second step is warranted and the impairment loss is measured as the difference between the carrying value and fair value of the asset group.

Although the test may appear straightforward, certain accounting and valuation challenges arise in practice. These include:

- *Identifying the asset group* — The asset group is the unit of account used to test long-lived assets. The asset group is established at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. This becomes challenging, and can be highly judgmental. For example, are there independent cash flows that are tracked by product? By store? By division? By subsidiary? Even so, are there significant common or intercompany assets or charges that should be taken into account? Are there common operating systems or other interdependencies? For some assets, for example a building that houses corporate headquarters, the testing level may encompass the entire company.
- *Developing the cash flow estimates* — Once the asset group level is identified, cash flow projections for the

asset group are developed. Cash flow estimates should be based on the company's estimates of the asset or asset group's existing service potential based on the life of the primary asset of the asset group. The primary asset is the principal long-lived asset being depreciated or amortized that drives the cash flow-generating ability of the group, which may not necessarily be the longest-lived asset in the group. Questions to consider in identifying the primary asset include whether other assets of the group would have been acquired without the asset, the level of investment needed to replace the asset, and the remaining useful life of the asset relative to the other assets in the group.

It is important to note that the first step is not a fair value measurement. This is because the cash flows used in the first step relate to the recoverable amount of the asset or asset group. The cash flows in the first step are undiscounted and are prepared using entity-specific assumptions. The second step is a fair value measure. The intricacies of the fair value standard extend beyond the scope of this paper; however, the basic principles view fair value as an exit price, or the price that would be received from the sale of an asset or paid to transfer a liability, using market participant assumptions. For the second step, cash flows will need to be determined from the perspective of a market participant considering, among other things, the most advantageous market and assumptions around the highest and best use of the asset or asset group. Therefore, the projections used in the first step of the impairment test could very well differ from the projections in the second step.

- *Service potential assumptions* — Cash flow projections used in the first step may include assumptions that increase the output of an asset group, provided the facts and circumstances support such assumptions and that the projections don't exceed the primary asset's existing service potential or require additional capital investment. For example, the projections could assume 75 percent utilization from the primary asset (e.g., a power plant) that is currently operating at 60 percent of existing service potential or capacity. Similarly, future capital expenditures that are necessary to maintain existing service potential (e.g., to replace component parts of the primary asset) should be included in the cash flow projections. In contrast, capital expenditures that

would add capacity to the plant (e.g., a second turbine that would expand capacity beyond the existing plant's service potential) should be excluded from the cash flow projections.

- *Residual or terminal value* — Because the discrete period projections are forecast through the end of the primary asset's useful life, some value may remain at the end of the projection period and should be included in the sum of undiscounted cash flows. This residual or terminal value represents the cash flows associated with the eventual disposition of the asset or asset group, which may include items such as the selling costs, release of working capital, and/or salvage value of the asset or asset group that remains at the end of the primary asset's useful life. Calculating the terminal value becomes even more complex if the asset group constitutes a business such as a reporting unit.

When the long-lived asset group constitutes a business, the residual value may need to be estimated using a pricing multiple or capitalization of earnings model, both adjusted to exclude growth beyond the existing service potential of the asset group. The calculated residual value would be added to the undiscounted cash flows generated over the life of the primary asset, with the sum compared to the carrying value of the asset group.

- *Allocating impairment loss* — Once an impairment loss is measured, the loss should be allocated pro rata only to the long-lived depreciable or amortizable assets in the asset group, based on the relative carrying amounts of those assets. However, where fair value is determinable without undue cost and effort, the allocated losses should not decrease the carrying value of any asset subject to impairment below its fair value.

## Managing market expectations

In a recent study<sup>1</sup> examining equity pricing movement in relation to goodwill impairment announcements, PwC noted that goodwill impairment announcements typically have a muted effect on stock prices by the time of the announcement. This lack of pricing impact may be due, in part, to "early warning disclosures" or other signals regarding the potential for impairment. Where possible,

<sup>1</sup> See [\*TS Insights, Market Turmoil and Goodwill Implications — a Study of the Market Response to Goodwill Impairments\*](#)

companies should consider early warning disclosures as a tool to avoid springing surprise impairment announcements onto its investors and other market constituents. A surprise impairment charge may serve as a market signal that troubled water is deeper than expected.

Indeed, the Securities and Exchange Commission staff continue to stress that disclosure of the potential for impairment resulting from the impact of market conditions should generally precede the period in which an impairment is taken. In their SEC filing review processes, the SEC staff focus considerable attention on impairments, including on the models and assumptions used by management in forming its conclusions and on the disclosure, timing of potential impairment and any related charge. There has also been focus on why impairment charges have not been taken, especially for companies that have seen their market capitalization deteriorate to levels below the book value of net assets.

### What this means for your business

Market conditions have sparked a wave of scrutiny focused on financial reporting matters, with impairment testing front and center. As briefly discussed in this publication, the determination of whether and if so how much a long-lived asset is impaired is quite challenging. Companies should be mindful of the specific facts and circumstances that will influence the valuation, the related financial reporting impact, and the resulting potential market and regulatory scrutiny. As such, companies should coordinate their impairment analyses with their auditors and valuation specialists, and should ensure that key assumptions used and judgments employed are well-documented.

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To help CFOs and their teams successfully navigate the current economic environment, PricewaterhouseCoopers is launching a series of *TS Insights* focused on financial reporting in an uncertain economy. The series helps to educate financial statement preparers about transactions and reporting issues that require special attention in today's environment. *TS Insights* is a publication of the Transaction Services group at PricewaterhouseCoopers, which includes approximately 1,000 professionals in 16 US cities.

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