



Assessing impairments*

A guide to testing of impairments of long-lived and indefinite-lived assets, including goodwill

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 forecast operating losses and downsizing efforts, have led many companies to focus greater attention on asset values and whether there might be associated impairment charges. This is especially true for historically acquisitive companies—regardless of industry—that have significant amounts of recorded goodwill and intangible assets on their balance sheets. As a result, many are going beyond their annual testing of goodwill and other indefinite-lived intangible assets for impairment by undertaking processes they may not have performed during historical periods

of growth and stability, such as testing long-lived amortizable 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, seek accounting and valuation assistance when needed, and potentially avoid costly, last-minute surprises.

Are the rules the same for the testing of all long-lived assets?

The rules for testing long-lived amortizable tangible and intangible assets are different from the rules for testing indefinite-lived intangible assets. The rules for testing goodwill

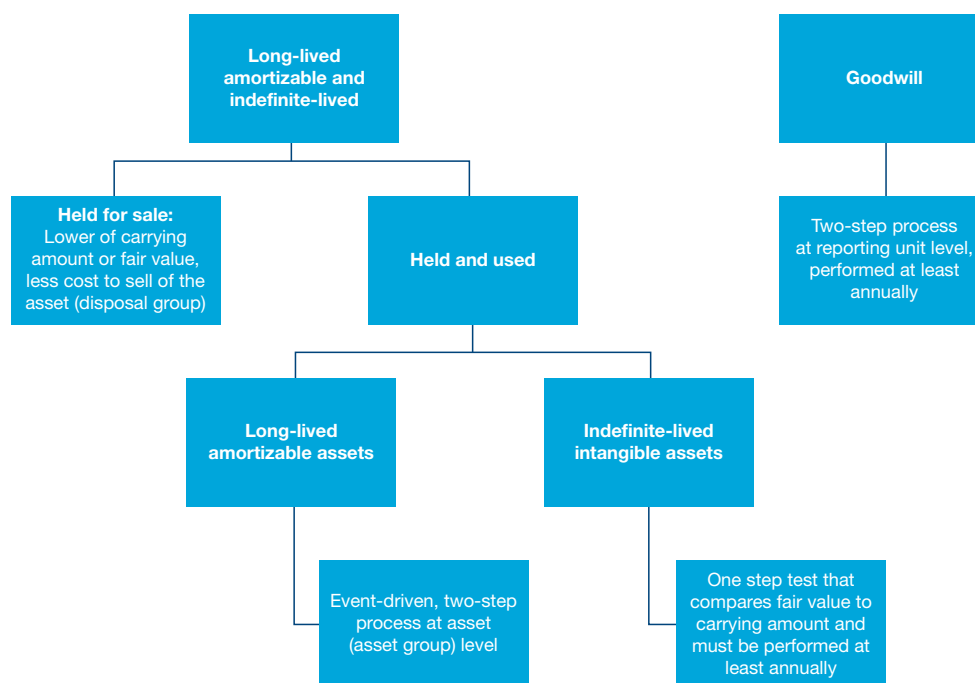
are different as well. The rules also differ if the test is performed on assets that qualify as held for sale or on assets that will be held and used.

At a minimum, indefinite-lived intangible assets and goodwill must be tested for impairment annually. Testing should also occur between the annual testing dates if events suggest that the fair value of the business or asset to be tested is below the unit's carrying amount. Long-lived assets, on the other hand, should be tested for recoverability whenever events or changes in circumstances indicate that the carrying amount of the asset or asset group may not be recoverable (i.e., a triggering event).

Triggering events or changes in circumstances that may warrant impairment tests on long-lived assets

- Significant decrease in the market price of a long-lived asset (asset group)
- Significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in the asset's physical condition
- Significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or adverse assessment by a regulator
- Accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)
- Current-period operating or cash flow loss combined with a history of operating or cash flow losses, or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)
- Current expectation that more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life

These impairment indicators are examples and should not be considered the only indicators. If an entity identifies additional impairment indicators for its specific operations, those indicators should also be considered. In the absence of a specific indicator, management may initiate impairment testing anytime it believes an impairment may exist.



Can a company change the annual date for goodwill impairment assessment?

The annual goodwill impairment test may be performed at any time during the fiscal year, provided the test is performed at the same time every year. Different reporting units may be tested for impairment at different times. Accordingly, a company is required to adopt an accounting policy to elect the date(s) to perform its annual impairment testing of goodwill for each reporting unit. However, in certain circumstances, a company may want to consider changing its date for goodwill impairment measurement.

From a practical perspective, a company may be interested in moving up its impairment testing—for example, from year-end to an earlier date—so as to reduce the amount of work being performed during the year-end closing process

and to facilitate timely interactions with any third-party valuation specialists.

A company that elects to change the date(s) of its annual goodwill impairment testing requires justification of the change in accounting principle on the basis of preferability. Determining whether such a change is preferable is a matter of judgment and based on company-specific facts, and a company should consider a number of factors, including:

- Does moving the measurement date to an interim date better align with the company's budgeting and strategic-planning cycle, including reporting to the board of directors?
- Does moving the measurement date to an interim date that is sufficiently close to year-end (e.g., within 90 days) potentially provide better information for users (e.g.,

banks and board of directors) of the financial statements by providing interim reporting of an impairment while still having a measurement date highly relevant to the year-end balance sheet date?

- Does moving the measurement date to an interim date assist financial statement users by providing greater comparability with competitors that use an interim date?
- Does moving the measurement date to an interim date allow the company to release its year-end financial statements in a more timely fashion than if a year-end measurement date were used?

In addition to preferability, a company would also need to ensure the following when changing its measurement date:

- More than a 12-month period of time has not lapsed since the acquisition date or most recent annual testing date.
- The change in testing dates did not accelerate, delay, or avoid a potential impairment charge.
- Management recognizes that this change in the annual impairment testing date does not change its responsibility to perform impairment testing at interim dates in the future, should a triggering event occur.
- As described earlier, changing the measurement date for the annual goodwill impairment test requires a robust and diligent analysis to support the change. Management should work closely with its independent auditors to ensure the change is preferable and to avoid delays in the process.

How does a company perform the impairment test on goodwill and indefinite-lived intangible assets?

Goodwill

The first step in the goodwill impairment test is to assess whether a reporting unit's fair value is less than the unit's carrying amount. A reporting unit is the same as, or one level below, an operating segment. If the reporting unit's fair value exceeds its carrying amount, then no impairment is indicated and no further analysis is required. However, if the fair value of the reporting event is less than the carrying value, the second step is to measure the amount of any goodwill impairment. Since goodwill is by definition a residual, the implied value of goodwill is determined by revaluing all tangible and intangible assets, as well as liabilities, and then subtracting that net asset value from the fair value of the reporting unit. If the implied value of goodwill is greater than its recorded amount in the second step, a company does not record a goodwill impairment. Impairment testing on all other accounts, as well as any resulting write-downs, must be performed before goodwill testing. Just as goodwill impairment testing has its own prescriptive framework, most other asset categories do too, particularly long-lived assets such as fixed assets and intangible assets that are held and used. Only after the results of all other impairment tests on held and used assets have been considered can a company determine the carrying amount of its reporting units. Assets that are held for sale should be tested for impairment as part of the disposal group after goodwill impairment testing is complete.

When performing the goodwill impairment test, a company should consider whether the fair value of the reporting unit can be maximized—from a market participant perspective—through a nontaxable or taxable transaction. In either scenario, it's likely that the deferred taxes attributable to the reporting unit in the first step (actual deferred tax balances) would be different in the second step (based on a current hypothetical transaction). Accordingly, simply carrying forward actual deferred tax balances to the second step may not be appropriate. The second step is not just a revaluation of the identifiable intangible assets already on the books. It is a full valuation of the reporting unit's assets and liabilities, conducted as though the unit were a newly acquired business (i.e., a purchase price allocation), which entails valuing items that might not already be held at fair value, such as inventory, fixed assets, and debt, as well as any homegrown intangible assets not currently recorded on the company's books. This purchase price allocation is performed only in an assessment of goodwill for impairment and does not change the recognition or measurement of these assets and liabilities in the financial statements. This may result in a higher impairment charge than originally anticipated.

Indefinite-lived intangible assets

The impairment test for indefinite-lived intangible assets that are held and used includes comparing the fair value of the asset with its carrying value. The impairment charge represents the amount by which the asset's carrying value exceeds the fair value.

How does a company perform the impairment test on long-lived amortizable assets?

The impairment test for long-lived amortizable assets varies depending on whether or not the asset is classified as held and used or held for sale. Assets that are held for sale should be recorded at their fair value minus cost to sell. The impairment test for long-lived assets that are held and used consists of two steps: The first step compares the sum of the undiscounted cash flows associated with an asset or group of assets (hereinafter asset group) with 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. If the recoverable amount is less than the carrying amount, a second step is warranted; the impairment loss is measured as the difference between the carrying value and the fair value of the asset group.

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

- **Identification of the asset group:** The asset group is the unit of account used for testing 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.

- **Development of the cash flow estimates:** Once the asset group level has been 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. Considerations in identifying the primary asset include (1) whether other assets of the group would have been acquired without the asset, (2) the level of investment needed to replace the asset, and (3) 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 by using entity-specific assumptions. The second step is a fair value measure. In this step, if cash flows are used for determining fair value, those 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 cash flow projections used in the first step of the impairment test could very well differ from the cash flow projections used in the second step.

- **Assumptions about the asset (asset group's) potential capacity:** Cash flow projections used in the first step may include assumptions that increase the output of an asset group, provided that 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. That residual or terminal value represents

the cash flows associated with the eventual disposition of the asset or asset group, which may include such items as 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 by using a pricing multiple or a capitalization-of-earnings model, both of them 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 with the carrying value of the asset group.

- **Allocation of impairment loss:** Once an impairment loss has been 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, when 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.

What valuation technique should a company use?

Goodwill

Private companies often perform their goodwill impairment test by using a discounted cash flow approach,

since active public markets usually do not exist and public company comparables may be challenging to find. However, valuation is an art, not a science, and therefore management should consider the use of multiple valuation approaches in determining

the fair value of a reporting unit. Those approaches may include discounted cash flow analyses and market-based approaches such as an analysis of similar public-trading multiples and comparable transaction multiples.

Long-lived assets excluding goodwill

Typical valuation methodologies for long-lived assets other than goodwill include the following:

Intangibles	Possible valuation methods
Brands and trademarks	Relief-from-royalty method, price-premium method, and recent market transactions (if available)
Technology	Relief-from-royalty method, incremental-cash-flow method, would also consider multiple-period excess-earning method (MEEM) if the technology is enabling
Customer relations and order backlog	MEEM approach (most prevalent)
Customer lists	Replacement costs
In-process research and development	Reproduction costs, discounted-cash-flow method, and MEEM
Software	Relief-from-royalty method, and replacement costs
Real property	Market approach and income approach
Machinery and equipment	Replacement costs, may also consider market approach for significant assets

Do recently issued accounting pronouncements impact the determination of fair value as used in impairment testing?

Yes, cash flow forecasts developed for impairment testing should consider cash flows that are achievable by a market participant. Market participants are defined as knowledgeable, able, and willing buyers and sellers in the principal (or most advantageous) market for a given asset. For example, even if management believes it can guide a particular reporting unit through current economic conditions without significant operational impact, the assessment of fair value should be made from the perspective of a market participant. This should include consideration of how the market participant expects the reporting unit to perform. That view may impact a number of assumptions employed within cash flow projections, including the revenue growth, profit margins, long-term-growth rates, discount rates, and risk premiums used in cash flow projections.

Should a company consider current market conditions when determining its cash flows?

As economists lower their estimates of forecast domestic and global macroeconomic growth in light of current market events, companies should consider how those events might similarly impact their forecasts of near- and long-term cash flows. There may be heightened uncertainty about the amount and/or timing of cash flows, particularly for industries in which customer purchases are discretionary. Further, rapidly changing markets may indicate that cash flow projections need to be revisited frequently.

What should a company do if it thinks it has an impairment?

The rules surrounding impairment tests can be complex, so it will be important to read the guidance. A company should also consider the complexity involved in valuing both tangible and intangible assets. The skills necessary to properly complete a valuation may not exist within every company, so the use of a valuation specialist may be appropriate. Valuations are often based on internal budgets and projections. A company should revisit these projections to ensure they are reasonable and reflect management's best estimates. Finally, a company should discuss the potential impairment with key stakeholders—including investors and lenders—because impairment charges might affect the company's ability to comply with debt covenants.

Going forward

Today's economic uncertainties, coupled with the complexities of asset impairment testing, will require companies to critically assess the assumptions used in their analyses. There may be more close calls than in years past, and there may be challenges in the undertaking of the difficult task of performing all of the valuations required within a compressed time frame. Accordingly, a company should begin its testing process early and consider seeking outside accounting and valuation assistance. A company should make sure its independent auditor is involved throughout the process in order to avoid last-minute surprises or delays. In short, a company shouldn't go it alone.

A company should gather as much information as possible to support the analyses. Documentation and

disclosure of key judgments and assumptions—with a particular emphasis on how they reflect current economic conditions and represent market participant assumptions—will be important, especially given the current turbulence in the capital markets. Even at companies that do not recognize an impairment, management should consider early-warning disclosures and should structure company plans to further evaluate the business for impairment in future periods. It may be some time before we understand the long-term implications of the current crisis on valuations, but we know one thing for sure: impairment testing will play a critical role in the financial-reporting process.

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