IMPAIRMENT TESTING OF LONG-LIVED ASSETS TO BE HELD AND USED

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Introduction

FASB Accounting Standards Codification (ASC) Topic 360, “Property, Plant, and Equipment,” provides guidance for the impairment of long-lived assets that are classified as held and used. In particular, the relevant guidance is included in the “Impairment or Disposal of Long-Lived Asset” subsections of ASC 360-10. This guidance requires the following multi-step approach to impairment testing:

1. Consider whether indicators of impairment are present for the asset group
2. If indicators of impairment are present that indicate the carrying amount of the asset group may not be recoverable, determine whether the carrying amount of the asset group is recoverable, based on a comparison of the total undiscounted future cash flows from the asset group to the carrying amount of the asset group
3. If the carrying amount of the asset group is not recoverable, an impairment loss should be measured based on the excess of the carrying amount of the asset group over the fair value of the asset group.

This guidance is applicable to all long-lived assets subject to amortization that are classified as held and used, regardless of whether they are tangible or intangible assets. Assets that are subject to this guidance include property and equipment, assets acquired under capital leases, long-term prepaid assets and finite-lived intangible assets. This white paper is intended to address the guidance for testing these long-lived assets for impairment and certain issues that have arisen in practice.

Asset group determination

An asset group is the unit of account for long-lived assets classified as held and used and therefore must be identified prior to the impairment testing. As discussed in ASC 360-10-35-23, an asset group is the grouping of assets and liabilities that represents the lowest level of identifiable cash flows that are largely independent of the cash flows of other groups of assets and liabilities. If the lowest level of identifiable cash flows depends on cash flows generated by other assets, the asset group should be established at a higher level. By its nature, the determination of asset groups is very judgmental and will depend on the specific facts and circumstances. The intent of this grouping of assets is for testing to be performed at a relatively low level of an entity. Some examples of common asset groupings include those assets that are part of an individual production line, manufacturing plant, or retail store. In certain limited situations, a long-lived asset (such as a corporate headquarters) may not have identifiable cash flows that are largely independent of the cash flows of any other asset groups, in which case the asset group for that long-lived asset would include all assets and liabilities of the entity.

In most cases, an asset group will consist of assets in addition to the long-lived asset being evaluated for impairment. This is because most long-lived assets do not generate cash flows without other complementary assets. Because the unit of account for evaluating long-lived assets for impairment is based on the identifiable cash flows generated, any long-lived asset that does not generate its own cash flows cannot be considered the unit of account (i.e., asset group) by itself. For example, a customer relationship intangible asset does not generate cash flows without other assets, such as the finished goods inventory that will be sold to the customer, the equipment that will be used to manufacture the raw materials into finished goods and working capital. This often is misunderstood, and entities may initially perform testing on the individual long-lived asset rather than the asset group. Generally, this is because entities determine the fair value of an individual long-lived asset in certain other circumstances, such as when applying the acquisition method in a business combination. Therefore, they may incorrectly believe the long-lived asset itself is the appropriate level for impairment testing.

We also have seen circumstances in which entities had initially determined asset groups based on their operating segments or reporting units used for goodwill impairment testing. While these may be the same in some cases, the determination of asset groups must be made based on the definition of an asset group rather than an entity’s operating segments or reporting units.

Impairment indicators

Long-lived assets only are required to be tested for impairment if events or changes in circumstances indicate the carrying amount of the asset group to which they belong may not be recoverable. Existing information and analyses developed for management review of the entity's operations often will include the primary evidence needed to determine when impairment potentially exists. As discussed in ASC 360-10-35-21, examples of these types of events or changes in circumstances include the following:

- "A significant decrease in the market price of a long-lived asset (asset group)"
- "A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition" (For example, a restructuring that results in a significant reduction in a plant's output.)
- "A 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 assessment by a regulator." (For example, a new law that affects the entity's ability to utilize its facilities or sell its products, a significant new competitor entering the market, or certain assets becoming subject to environmental clean-up laws.)
- "An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)" (For example, significant cost overruns on the construction of a new plant.)
- "A 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)."
- A 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 examples are not all-inclusive, and entities also should evaluate whether other events or changes in circumstances have occurred that could indicate the carrying amount of the asset group is not recoverable. For example, events or changes in circumstances such as evidence of a physical defect in a long-lived asset included within an asset group, impairment of other assets included within an asset group, major order cancellations or changes in the technological environment also may be indicators of impairment. If indicators of impairment are present that indicate the carrying amount of the asset group may not be recoverable, an entity must move on to the next step of the test to determine whether the carrying amount of the asset group is recoverable.

Recoverability of the carrying amount of an asset group

The carrying amount of an asset group is considered recoverable if the total undiscounted future cash flows from the asset group are greater than the carrying amount of the asset group. The carrying amount of an asset group should be determined based on the aggregate of the carrying amounts of the assets included in the asset group. These carrying amounts (other than goodwill) should be adjusted based on other applicable U.S. generally accepted accounting principles prior to testing the asset group for recoverability. Goodwill would only be included in an asset group if the group is or includes the related reporting unit with goodwill. The carrying amount of any goodwill included in an asset group should not be adjusted for potential goodwill impairment prior to testing the asset group for recoverability. Furthermore, debt is generally not included in an asset group as the cash outflows for debt are generally separately identifiable from other cash flows.

As discussed in ASC 360-10-35-29 and 30, the total undiscounted cash flows used to compare to the carrying amount of the asset group should include only the future cash flows that are directly associated with and that are expected to arise as a direct result of the use of the asset group and its eventual disposition (i.e., future cash inflows expected to be generated by an asset group less the future cash outflows expected to be necessary to obtain those inflows). These cash flow estimates should exclude cash outflows for interest and generally should be determined on a pre-tax basis.

The assumptions used in developing these estimates must be based on the entity's intended use of the asset group (i.e., entity-specific) and should represent management's best estimates of the future outcomes. If an entity has a reasonable basis to assume that prices or volumes will increase from existing levels, it is appropriate to include these increases in the cash flow estimates. For example, if an asset group includes a group of acquired customer relationships, the estimated cash flows should include both those from acquired customers as well as new customers. However, cash flow estimates should only include those amounts that can be generated based on the asset group's existing potential or capacity exclusive of additional capital expenditures. As a result, any volume increases an entity includes in its estimated cash flows would be limited to those volumes that can be produced with the asset group's existing potential or capacity. Furthermore, cash flows for items such as repairs and maintenance to maintain an asset group's existing potential or capacity should be included as part of the asset group's cash outflows.

The estimates may be a point estimate of the most likely outcome or a range of possible outcomes. If a range of possible outcomes is used, the probability of each possible outcome should be considered. Furthermore, these assumptions must be reasonable as compared with the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans or information communicated to others such as lenders, management or the board of directors.

As discussed in ASC 360-10-35-31, the time period for estimating cash flows from the use of an asset group generally should be based on the remaining useful life of the primary asset of the group to the entity. The primary asset of an asset group cannot be land or an intangible asset not being amortized. As discussed in ASC 360-10-35-32, factors that an entity generally should consider in determining the primary asset of an asset group include the following:

- Whether other assets of the group would have been acquired by the entity without the asset
- The level of investment that would be required to replace the asset
- The remaining useful life of the asset relative to other assets of the group

In addition to the estimated cash flows from the use of an asset group during the primary asset's remaining useful life, the estimated cash flows from the eventual disposition of the asset group also must be considered. If the primary asset is not the asset of the group with the longest remaining useful life, estimates of future cash flows for the group should assume the sale of the group at the end of the useful life of the primary asset. Furthermore, if the asset group meets the definition of a business, the cash inflows from the sale of that business at the end of the primary asset's useful life would need to be estimated. When estimating these cash inflows certain fair value principles may need to be considered, such as a discounted cash flow technique or other fair value techniques, adjusted to exclude any growth beyond an asset group's existing potential or capacity as noted previously.

If the undiscounted cash flows from the use and disposition of the asset group are greater than its carrying amount, the asset group's carrying amount is considered recoverable and therefore is not impaired. This is the case even if the fair value of the asset group, or the individual long-lived asset within the asset group, is less than its carrying amount, which often is misunderstood in practice. While there would be no impairment in these situations, consideration should be given to adjusting the useful lives of the long-lived assets for depreciation or amortization purposes, as appropriate. If the undiscounted cash flows from the asset group are less than its carrying amount, the asset group is considered to be impaired and the fair value of the asset group must be determined in the next step of the impairment test and compared to its carrying amount to determine the impairment loss.

Fair value of an asset group

The fair value of an asset group must be determined based on the guidance in ASC 820, “Fair Value Measurement,” which states that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. As discussed in ASC 360-10-35-36, an expected present value technique often will be used to estimate the fair value of an asset group. Because the determination of fair value is based on market participant assumptions, the estimated cash flows used in an expected present value technique may differ from those used in the recoverability test as those cash flows were determined using entity-specific assumptions. This potential difference in cash flows often can be overlooked.

Another issue that comes up in practice is that entities may improperly determine the fair value of an individual long-lived asset within an asset group in this step of the impairment test, rather than the fair value of the asset group as a whole. This may occur because entities often determine the fair value of an individual long-lived asset in certain other circumstances, such as when applying the acquisition method in a business combination, as noted previously.

If the fair value of the asset group is less than its carrying amount, the excess of the carrying amount above the fair value generally should be recognized as an impairment loss. The adjusted carrying amount of a long-lived asset that is impaired should be its new cost basis, which should be depreciated (amortized) over the remaining useful life of that asset.

Allocation of impairment loss

As discussed in ASC 360-10-35-28, any impairment loss for an asset group should reduce only the carrying amounts of the long-lived assets of the asset group. In addition, the loss should be “allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group should not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable without undue cost and effort.”

The following example is adapted from ASC 360-10-55-21 and 22 and illustrates the allocation of an impairment loss to the long-lived assets of an asset group:

> An entity owns a manufacturing facility that together with other assets is tested for recoverability as a group. In addition to long-lived assets (Assets A-D), the asset group includes inventory that has already been tested for impairment under the appropriate guidance, and other current assets and liabilities that are not covered by ASC 360-10. The $2.75 million aggregate carrying amount of the asset group is not recoverable and exceeds its fair value by $600,000. In accordance with ASC 360-10-35-28, the impairment loss of $600,000 would be allocated as shown below to the long-lived assets of the group.

Asset group	Carrying amount	Pro rata allocation factor	Allocation of impairment (loss)	Adjusted carrying amount
Current assets	$400,000	-%	$ -	$400,000
Liabilities	(150,000)	-	-	(150,000)
Long-lived assets				
Asset A	590,000	24	(144,000)	446,000
Asset B	780,000	31	(186,000)	594,000
Asset C	950,000	38	(228,000)	722,000
Asset D	180,000	7	(42,000)	138,000
Subtotal	2,500,000	100 %	(600,000)	1,900,000
Total	$2,750,000		($600,000)	$2,150,000

If the fair value of an individual long-lived asset of an asset group is determinable without undue cost and effort and exceeds the adjusted carrying amount of that asset after an impairment loss is allocated initially, the excess impairment loss initially allocated to that asset would be reallocated to the other long-lived assets of the group. For example, if the fair value of Asset C is $822,000, the excess impairment loss of $100,000 initially allocated to that asset (based on its adjusted carrying amount of $722,000) would be reallocated as shown below to the other long-lived assets of the group on a pro rata basis using the relative adjusted carrying amounts of those assets.

Long-lived assets of asset group	Adjusted carrying amount	Pro rata re-allocation factor	Reallocation of excess impairment	Adjusted carrying amount after reallocation
Asset A	$446,000	38 %	($38,000)	$408,000
Asset B	594,000	50	(50,000)	544,000
Asset D	138,000	12	(12,000)	126,000
Subtotal	1,178,000	100 %	(100,000)	1,078,000
Asset C	722,000		100,000	822,000
Total	$1,900,000		$ -	$1,900,000

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