HOT TOPIC

Impairment

Nonfinancial asset impairment in a period of economic uncertainty

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KPMG discusses impairment considerations for goodwill, indefinite-lived intangible assets and long-lived assets.

The past several months have seen threats of a recession, increasing inflation, declining share prices, the Russia-Ukraine war and rising interest rates, all of which have created economic uncertainty.

"A majority (91 percent) of U.S. CEOs believe that there will be a recession in the next 12 months; and only 34 percent think it will be mild and short."

KPMG 2022 US CEO Outlook: Growth Strategies for Turbulent Times

"Core inflation remains stubbornly high. The Fed must act aggressively to contain it. The move in September was only the first across the threshold into restrictive territory. Brace yourself; more rate hikes are coming."

KPMG Economics: Inflation still Burns

Although there has been much focus on the economic impact of these trends and events, the accounting impacts, including the effect on impairment of nonfinancial assets, cannot be overlooked. Do these economic trends and events represent triggering events for impairment testing of goodwill, indefinite-lived intangibles or long-lived assets? Do they affect a fair value analysis?

General questions that companies should be asking include the following:

- Has our share price significantly decreased?
- Has our cost of capital increased?
- Are we unable to pass on our increased costs of doing business to customers?
- Have the circumstances significantly changed how we expect to use our long-lived assets, or the period over which we will use them?
- Are our customers struggling to pay their obligations?
- Have we revised our revenue or earnings guidance downward?

If the answer to any of these questions is 'yes', a triggering event may have occurred, and additional attention may be required when testing nonfinancial assets for impairment.

Goodwill & indefinite-lived intangible assets

Goodwill and indefinite-lived intangible assets are tested for impairment on an annual basis or more frequently if events occur or circumstances change to indicate they are more likely than not impaired (i.e. a triggering event). When testing for impairment, the company compares the fair value of the intangible asset or goodwill reporting unit to its respective carrying amount. If the carrying amount exceeds fair value, an impairment charge is recognized.

Triggering events

In times of uncertainty, a company needs to consider whether the impact of the current economic conditions gives rise to a triggering event for both goodwill and indefinite-lived intangible assets. In our current environment, macroeconomic conditions such as declining share prices, increases in cost of capital and inflation are factors that may present a unique environment for evaluating triggering events compared to previous assessments. Although Subtopics 350-20 and 350-30 discuss several examples that are indicative of a triggering event, the following table focuses on situations that may be new or unique in the current environment. For a general discussion of triggering events, see section 4.3 of KPMG Handbook, Impairment of nonfinancial assets.

Recent declines in share prices	
Is a sustained decline in a company's share price a factor in evaluating triggering events for goodwill?	Yes, it is a factor to consider because it could indicate the fair value of the reporting unit is less than its carrying amount. In addition, such a decline often indicates economic and/or other factors that may produce a triggering event. For a discussion of evaluating negative share price trends as a triggering event, see section 4.3.20 of KPMG Handbook, Impairment of nonfinancial assets.
Are the current equity markets disorderly thereby requiring adjustments to equity values?	We believe the equity markets are generally efficient and provide a meaningful indicator of fair value. While they have experienced declines this calendar year, we do not believe they would be considered disorderly; instead, we believe they are active. Therefore, we would not adjust equity values used in impairment testing for any type of illiquidity or mark-to-model techniques.
Is a decline in share price a factor in evaluating triggering events for indefinite-lived intangible assets?	It depends, while a decline in share price may not directly impact the fair value of an indefinite-lived intangible asset, the underlying factors driving a decline in share price should be considered. If the underlying factors indicate a potential reduction in anticipated cash flows, then an entity should focus on whether such events could affect the fair value such that it is more likely than not the asset is impaired. [350-30-35-18B – 35-18C]
Recent increases in interest rates	
Are increases in interest rates a factor in evaluating triggering events?	Yes, increased interest rates are macroeconomic conditions that could affect an indefinite-lived intangible asset or a reporting unit's fair value by increasing the cost of available capital and the resulting discount rate used in the valuation. This circumstance could create a triggering event if it indicates that the fair value is

	less than the carrying amount. In particular, this circumstance requires close attention when: • impairment test results are sensitive to higher rates; and • there is limited headroom (e.g. due to a recent business combination comprising a separate reporting unit or partial impairment in a recent period, both situations resulting in fair value equating to carrying amount in the prior valuation). Any 'headroom' between the fair value and carrying amount of the asset may be compressed or eliminated given an increase in the discount rate and changes to underlying assumptions.
Rising inflation	
Is the existence or impact of inflationary indicators a factor in evaluating triggering events?	The **existence** of inflationary indicators may not be a triggering event, but the **impact** of inflation on the fair value of an indefinite-lived intangible asset or reporting unit may give rise to a triggering event. For example: • a triggering event may occur if a company is not able to pass on increased costs to customers or if increased pricing decreases customer demand; and • a company may be more sensitive to triggering events caused by inflation if its most recent quantitative assessment did not show a significant cushion between carrying amounts and fair values.
Potential recession	
Is a potential recession a factor in evaluating triggering events?	A potential recession may cause a triggering event to occur if it results in declining forecasts of future cash flows, revenue or earnings. A company should evaluate the impact of the current environment on its projected financial information, including how customer demand and changes in costs impact those amounts.

Impairment testing

When a company tests goodwill and indefinite-lived intangible assets for impairment (due to a triggering event or while performing its annual test) in the current economic environment, there may be unique factors to consider in determining the reporting unit's fair value. See chapter 8 of KPMG Handbook, Impairment of nonfinancial assets, for a discussion of fair value measurements.

Discount rate	The Federal Reserve has increased interest rates by 300 basis points in 2022. Because the risk-free rates have increased similarly, the discount rate used in the valuation will also increase, thereby reducing the discounted cash flows in the income approach and reducing the fair value, even if expected undiscounted cash flows have remained consistent. See section 8.3.50 of KPMG Handbook, Impairment of nonfinancial assets, for a discussion of discount rates.

Uncertainty of projected financial information	When economic conditions are distressed, we expect that entities will adjust both the expected future cash flows and the discount rate for the increased risk factors when compared to analyses in more stable market conditions. For example, it may be necessary to incorporate an entity-specific risk premium in the discount rate to reflect the increased uncertainty of expected future cash flows. In addition to the discount rate and financial projections, the long-term growth rate is another assumption that may be impacted, and previous long-term growth rate assumptions may need to be revised.
Qualitative test	Many companies perform a qualitative test as part of the annual impairment testing requirements. Current-year economic uncertainty may necessitate the use of different factors than for the prior year qualitative tests. Depending on a company's facts and circumstances, the likelihood of the qualitative test resulting in a more likely than not conclusion that the carrying value is greater than fair value (thereby requiring a quantitative test) may be higher in the current year. For a discussion of the qualitative assessment, see chapter 6 of KPMG Handbook, Impairment of nonfinancial assets.
Market capitalization reconciliation	The reconciliation of the fair value of a company's reporting units to its market capitalization serves as an overall check of the reasonableness of those reporting units' estimated fair values. Given current market volatility, it may be appropriate for management to consider the market capitalization based on an average share price over a reasonable period as a better estimate of the fair value. Generally, the reasonable period used in averaging the share price will precede and lead up to, but not go past, the measurement date. Changes in market prices after the measurement date are not considered in determining average market prices because they do not reflect conditions on that date. The length of the averaging period will depend on entity-specific facts and circumstances. For example, it may not be appropriate to consider prices in periods before certain company-specific events – e.g. loss of key customers, revision(s) in earnings guidance, reductions in workforce – because the change in price may not be due solely to volatility in the capital markets. In any case, we would expect a company to prepare robust documentation of its key judgments in determining the averaging period. For a general discussion of market capitalization reconciliation, see section 8.3.70 in KPMG Handbook, Impairment of nonfinancial assets.

Long-lived assets

The impairment testing for long-lived assets (e.g. property, plant and equipment; finite-lived intangible assets; lease right-of-use assets) is entirely trigger-based. These assets are tested for impairment when one or more events or circumstances indicate that the carrying amount of the long-lived asset group may not be recoverable.

A company may consider adjusting the projected cash flows used in not only its fair value estimates, but also its recoverability test. The cash flows are updated for known or expected events, such as the loss of a significant customer or a more general reduction in demand, an increase in costs or the incurrence of restructuring or severance costs. In addition, changes in management's plans or the company's ability to hold an asset or asset group may alter the period used for recoverability – i.e. the length of cash flows projected. In all cases, the projected cash flows used for the recoverability test need to be consistent with the information the company uses for both internal planning and external communication.

A sustained decline in share price may also be indicative of other underlying facts and circumstances potentially affecting the recoverability of long-lived assets. Although Topic 360 does not mention market capitalization and share price trends as potential triggering events, the relevance of the underlying factors driving the decline in share prices should not be ignored. For example, a decline in share prices may signal weakening demand for a product, resulting in reduced cash inflows and potential impairment for an asset group.

If a company has determined that the carrying amount of an asset group is not recoverable, then a Step 2 fair value test is performed to quantify the impairment. The factors relevant to an indefinite-lived intangible or a reporting unit's fair value test (e.g. the effect of discount rates) may also be relevant to a long-lived asset group's fair value test.

Disclosures

A public company is required to disclose the potential for material impairment charges even if it has determined that no impairment charge is necessary for the current reporting period. These disclosures are required and generally would be expected to be disclosed in periods in advance of the charge. [Reg S-K Item 303(b)(2)(ii)]

The SEC staff has stated that it focuses on disclosures included in Management's Discussion and Analysis (MD&A) associated with goodwill impairment testing. The SEC staff has also discussed its expectation regarding the types of disclosures it expects in MD&A. [2009 AICPA Conf]

In addition, Topic 275 (risks and uncertainties) requires that the company disclose in its financial statements events or circumstances that could significantly affect the amounts that are reported in the financial statements. [275-10-50-8, 50-13]

For example, if a company has a reporting unit that is at risk of failing a future quantitative goodwill impairment test, and an impairment of goodwill allocated to that reporting unit could be material, the SEC staff would expect that company to highlight the risk of impairment in the notes to its financial statements as well as MD&A. Further, if the fair value of a reporting unit as of the date of the last impairment test is not substantially more than the carrying amount, the SEC staff expects the company to disclose:

- the percentage by which the fair value of the reporting unit exceeds its carrying amount;
- the amount of goodwill allocated to the reporting unit;
- a discussion of the assumptions used and any uncertainty inherent in those assumptions; and
- a discussion of the potential events and circumstances that could have a negative effect on the assumptions.

For a discussion on disclosures, see chapter 10 of KPMG Handbook, Impairment of nonfinancial assets.

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