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Technical Line

Accounting for impairment of goodwill and indefinite-lived intangible assets due to the coronavirus

In this issue:

What you need to know

- The economic fallout from the coronavirus (COVID-19) pandemic has raised questions about whether various assets are impaired.
- Affected entities will need to carefully evaluate whether to perform interim impairment tests for goodwill and indefinite-lived intangible assets.
- When required, the interim impairment tests for goodwill and indefinite-lived intangible assets are quantitative tests.
- Companies that have adopted ASU 2017-04 will apply a simplified quantitative impairment test for goodwill.
- Publicly traded companies that perform impairment tests should corroborate their fair value estimates for reporting units by reconciling the estimates with their market capitalization.

Overview

While the extent and duration of the economic fallout from the COVID-19 pandemic remain unclear, companies need to consider a number of accounting, disclosure and financial reporting matters.

This publication supplements our Technical Line, ***Accounting and reporting considerations for the effects of the coronavirus outbreak***, and provides more information for companies that need to consider whether indefinite-lived intangible assets or goodwill is impaired.

Building a better working world

The current economic environment, including the significant declines in many companies' share prices, market volatility and the disruptions to many companies' operations, may trigger an interim impairment analysis for indefinite-lived intangible assets and/or goodwill under Accounting Standards Codification (ASC) 350, *Intangibles – Goodwill and Other*, depending on a company's facts and circumstances.

Performing an impairment evaluation requires management to use significant judgment. Given the current uncertainties, evaluating assets for impairment will likely prove even more challenging now.

Order of impairment tests

Long-lived assets to be held and used (including finite-lived intangible assets), indefinite-lived intangible assets and goodwill may all need to be tested for impairment at the same time.

Impairment tests of all other assets should be completed and reflected in the carrying amount of the reporting unit before the goodwill impairment test is performed.

The order in which a company tests each asset or asset group within a reporting unit for impairment is important because the goodwill impairment model requires a comparison of the fair value of a reporting unit to its carrying amount as the measure of impairment. Impairment tests of all other assets (e.g., long-lived assets, inventory, equity method investments) should generally be completed and reflected in the carrying amount of the reporting unit before the goodwill impairment test is performed.[1] See our Technical Line, ***Accounting and reporting considerations for the effects of the coronavirus outbreak***, for more information on other asset impairment considerations. Companies should consider whether the prospective financial information (PFI) considerations discussed further below may also be relevant when testing other assets for impairment.

The graphic below shows the order in which assets generally need to be tested for impairment.

1. **Indefinite-lived intangible assets (ASC 350-30)***
   ▶ Annually, and more frequently if impairment indicators exist
2. **Long-lived assets to be held and used (ASC 360)**
   ▶ When impairment indicators exist
3. **Goodwill (ASC 350-20)**
   ▶ Annually, and more frequently if impairment indicators exist

*Other assets subject to impairment testing are tested at the same time (e.g., inventory, equity method investments).

Long-lived assets that are held and used include land, buildings, machinery and finite-lived intangible assets that do not meet the held-for-sale criteria. When a disposal group is held for sale, the order of impairment testing differs. Guidance on how to test long-lived assets to be held and used, and disposal groups that are held for sale, for impairment under ASC 360, *Property, Plant, and Equipment*, can be found in our Financial reporting developments (FRD) publication, ***Impairment or disposal of long-lived assets***.

This publication focuses on key aspects of testing goodwill and indefinite-lived intangible assets for impairment under ASC 350. Our FRD, ***Intangibles – goodwill and other***, provides comprehensive guidance on ASC 350.

Because many aspects of the impairment models for goodwill and indefinite-lived intangible assets are similar, the points discussed below apply to both indefinite-lived intangible assets and goodwill, unless we state that they apply only to one type of asset.

Impairment models under ASC 350

Unit of account

Indefinite-lived intangible assets

Intangible assets are assets that aren't financial instruments and lack physical substance. They include trade names, customer lists, and in-process research and development. An intangible asset must be amortized over its useful life, unless the useful life is indefinite.[2] Indefinite-lived intangible assets are tested for impairment under ASC 350-30 rather than amortized.

Separately recognized indefinite-lived intangible assets, whether acquired or internally developed, are combined into a single unit of account for impairment testing if they operate as a single asset and, as a result, are essentially inseparable from one another.[3]

Determining whether indefinite-lived intangible assets are essentially inseparable from one another requires judgment, based on all relevant facts and circumstances. ASC 350-30 provides a list to help companies make this determination. A company that aggregates multiple indefinite-lived intangible assets into a single unit of account must reconsider that determination in future periods, based on the facts and circumstances that exist at the time. See section 2.3.3 of our FRD, ***Intangibles — goodwill and other***, for more details.

Goodwill

Under ASC 805, *Business Combinations*, goodwill is an asset that is initially recognized in a company's financial statements when a business is acquired. It represents the future economic benefits that will arise from the assets acquired in the business combination that are not individually identified and separately recognized.[4] Goodwill is not amortized.[5]

Goodwill is tested for impairment at a level within a company that is referred to as the reporting unit. A reporting unit is an operating segment, as that term is used in ASC 280, *Segment Reporting*, or one level below an operating segment (referred to as a component), depending on whether certain criteria are met.[6] Goodwill cannot be tested for impairment at any other level in a company. See section 3.8 (before the adoption of Accounting Standards Update (ASU) 2017-04, *Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*) or section 3A.8 (after the adoption of ASU 2017-04) of our FRD, ***Intangibles — goodwill and other***, for further guidance on identification of reporting units. See the *Quantitative impairment test* section for more information on ASU 2017-04.

Frequency of impairment test

The guidance requires that both indefinite-lived intangible assets and goodwill are tested for impairment annually and more frequently if events or changes in circumstances indicate that it is more likely than not (i.e., a likelihood greater than 50%) that the intangible asset or the reporting unit is impaired. Therefore, during interim periods, ASC 350 requires companies to focus on those events and circumstances that affect significant inputs used to determine the fair value of the asset, asset group or reporting unit to determine whether an interim quantitative impairment test is required.

Given current economic and market conditions, companies should consider whether any of the following events or changes in circumstances have occurred in the current period to determine whether an interim quantitative impairment test of an indefinite-lived intangible asset (or asset group), a reporting unit or both is necessary. When an interim impairment test is triggered based on an impairment indicator, a quantitative test is required.

The following are examples of events and changes in circumstances that a company may consider when evaluating whether an interim impairment test may be required and are inclusive of the considerations listed in ASC 350-30-35-18B for indefinite-lived intangible assets and ASC 350-20-35-3C for goodwill:

- The company's stock price and its market capitalization suggest that the fair value of a reporting unit is less than its carrying amount.
- The company or its competitors have reported store closures (permanent or temporary), production slowdowns or shutdowns, including government-ordered shutdowns.
- Recent news articles or analysts' reports indicate a decline or expected decline in the performance in the company's market or industry.
- Competitors have recently recognized an impairment loss.
- Market multiples for competitors in the industry have declined.
- The company or its competitors have reported significant workforce shortages due to government-imposed restrictions on movement or have implemented workforce reductions (temporary or permanent) due to decreased demand for goods and/or services.
- The decrease in demand for goods and/or services results in the company being unable to meet contractual service thresholds or other contractual obligations that affect the useful life or fair value of an indefinite-lived intangible asset (e.g., airport slot rights).
- Raw materials or other operating inputs from other countries affected by the outbreak aren't available.
- A forecast of the business outlook or capital costs indicates that there may be a change in the recoverability of goodwill.
- Earnings remain at a level below forecasted levels, indicating that goodwill may not be recoverable.
- The company has experienced lower-than-expected earnings or expects lower earnings in the next quarter or year.
- The company has signaled to the market that earnings expectations for the quarter or year have been revised downward.
- The company has experienced a loss in operating cash flow or a net loss in the current period.
- The company projects continuing net losses or cash flow losses.
- There is a sustained decrease in the company's stock price (in either absolute terms or relative to the stock prices of its peers).
- The company more likely than not expects that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of.
- The company recognizes a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

An interim impairment test is required if events or changes in circumstances indicate that it is more likely than not that the intangible asset or reporting unit is impaired.

The events and factors listed above are examples and are not all-inclusive. None of these events or circumstances by itself would indicate that it is more likely than not that an indefinite-lived intangible asset or reporting unit is impaired. Instead, a company also weighs any positive or mitigating factors it identifies and holistically evaluates all events since the most recent quantitative impairment test to determine whether it is more likely than not that the asset or reporting unit is impaired.

Weighing the effect of various positive and negative factors may be challenging and will require the use of significant judgment. For example, a company that is experiencing higher than normal demand for its goods and services in the current environment (e.g., online retailers, delivery service providers, household paper product manufacturers) but is, at the same time, having difficulty sourcing certain raw materials to meet this demand due to supply chain disruptions will need to perform an evaluation of all facts and circumstances. More weight should be placed on those events and circumstances that most affect a reporting unit's fair value or the carrying amount of its net assets.

See sections 2.3.2, 3.1.1 and 3A.1.1 of our FRD, ***Intangibles — goodwill and other***, for further guidance on evaluating indicators of impairment for indefinite-lived intangible assets, goodwill before the adoption of ASU 2017-04 and goodwill after the adoption of ASU 2017-04, respectively. Also see sections 3.5 and 3A.5 of that FRD for additional guidance on the frequency of goodwill impairment tests. See the *Quantitative impairment test* section for more information on ASU 2017-04.

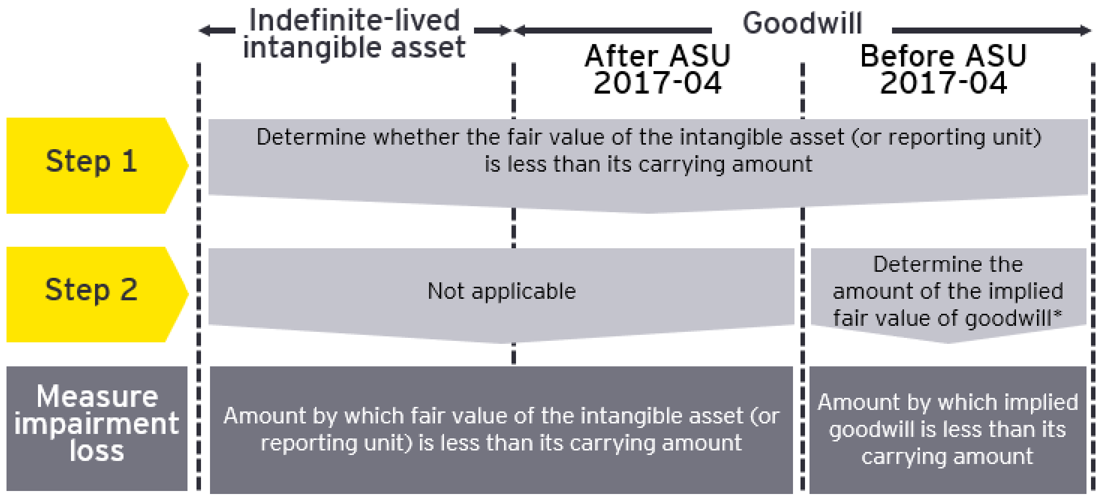
How we see it

In the current economic environment, many companies will conclude that an interim quantitative impairment test is appropriate. This will depend on the facts and circumstances, including consideration of existing headroom from the prior quantitative test (i.e., excess of fair value over carrying amount). Companies should also carefully evaluate and document how they considered any negative factors (e.g., business disruption, decline in stock price) in determining whether an interim test is required.

In performing this assessment, it is important to understand that the ASC 350 impairment models differ from an other-than-temporary-impairment model. The ASC 350 impairment model requires an analysis of the relationship between the fair value and the carrying amount of the reporting unit as of the test date and does not include a determination by management of whether a decline in fair value is temporary. However, it will be important for a company to consider how the severity and anticipated duration of the current market conditions are reflected in its determination of fair value.

Quantitative impairment test

When a company determines that it is more likely than not that an indefinite-lived intangible asset or a reporting unit is impaired, it must proceed with a quantitative impairment test. The illustration below summarizes how to perform this test, depending on the type of asset being tested and whether the company has adopted ASU 2017-04, which simplifies the testing for goodwill and requires only a one-step goodwill impairment test. See our FRD, ***Intangibles — goodwill and other***, for detailed application guidance.



* Fair value of reporting unit, minus the fair value of the assets and liabilities

ASU 2017-04 was effective on 1 January 2020 for annual and interim impairment tests for calendar year-end public business entities that meet the definition of a Securities and Exchange Commission (SEC) filer and are not smaller reporting companies, as defined by the SEC. The guidance is applied prospectively to goodwill impairment tests performed after the effective date (i.e., annual and interim tests).

For all other entities, the guidance is effective for annual periods beginning after 15 December 2022, but early adoption is permitted.

Calendar year-end smaller reporting companies that have not yet adopted the simplified goodwill impairment test are permitted to early adopt ASU 2017-04 in 2020. Adopting that guidance would eliminate step 2 of the goodwill impairment test and the burden of determining the implied fair value of goodwill to measure an impairment loss. When making this decision, a company should consider that:

- Because it will no longer perform step 2 after it adopts the guidance, the company would not be able to recognize an impairment charge based on its best estimate of probable loss if the quantitative impairment test is not complete before the financial statements are issued or are available to be issued. That is, ASU 2017-04 eliminates the legacy guidance on basing an impairment charge on a best estimate because companies are expected to be able to complete the simplified one-step test before issuing their financial statements (or making them available for issuance).

- Applying the simplified one-step test may increase the frequency of goodwill impairment charges. Under the legacy guidance, it is possible for a reporting unit to fail step 1 but for goodwill not to be impaired, based on how an impairment is measured in step 2.

Determination of fair value

Step 1 requires a company to determine the fair value of an indefinite-lived intangible asset or reporting unit. ASU 2017-04 did not amend ASC 820, *Fair Value Measurement*. Detailed guidance about measuring fair value can be found in our FRD, ***Fair value measurement***.

ASC 820, which provides the framework for measuring fair value, describes three valuation approaches: the market approach, the cost approach and the income approach. Generally accepted valuation techniques are consistent with these approaches, but a company needs to determine which approach or approaches are appropriate and whether there is adequate data available to use an approach. Determining the appropriate approach or approaches to use requires judgment, sufficient knowledge of the item being measured and an adequate level of expertise in applying the valuation technique(s). It may be appropriate to engage valuation professionals to assist with the application of the technique(s).

When sufficient and reliable data is available, more than one valuation technique should be applied.[7] Valuation techniques consistent with both the market approach and the income approach are commonly used.

Prospective financial information

Valuation techniques, particularly those that are consistent with the income approach (e.g., a discounted cash flow model), rely significantly on the use of internally developed PFI[8] as inputs into the analyses. Management will need to carefully evaluate and update the key PFI inputs and assumptions that are likely to significantly affect a company's determination of the fair value of a reporting unit based on recent market conditions. Examples of key PFI inputs that are common in valuation techniques include:

- Revenue
- Gross margin
- Earnings before interest, taxes, depreciation and amortization
- Selling, general and administrative expense
- Capital expenditures

Management will need to update prospective financial information used as key inputs into valuation techniques based on recent market conditions.

Depending on the valuation technique used, examples of other assumptions that may need to be applied to the PFI include:

- Discount rate
- Weighted average cost of capital
- Terminal growth rate
- Customer attrition rate
- Royalty rate

How we see it

Companies may have developed PFI and related assumptions in a prior annual or interim period to develop an operational forecast or accounting estimate. Management will need to update this PFI based on recent market conditions, taking into consideration the uncertainty associated with the coronavirus pandemic and its economic fallout. We would expect the PFI and related assumptions used to derive the fair value of intangible assets and reporting units to be consistent with the same information used in other asset impairment analyses.

A company's updated PFI will likely include a forecast of how quickly the company believes it will be able to return to normal operating capacity, and this will vary depending on the industry and geographical region(s) in which the company operates. We do not expect all industries or companies to be affected in the same manner. Companies will need to consider their facts and circumstances carefully.

The discount rate applied to the PFI should also be updated to appropriately reflect the entity-specific risk that management's projections may not be achieved. We generally expect entity-specific risk premiums applied to discount rates to increase, given the uncertainty in the current environment.

Market capitalization as a corroboration of fair value

While this is not required under US GAAP, a publicly traded company should reconcile the fair value of its reporting unit(s) to its stock price and market capitalization to corroborate its fair value estimates. While many public companies have multiple reporting units and may not use their market value to determine the fair value of their reporting units, we would expect companies to document and explain, in sufficient detail, the reasons for any significant difference between the sum of the fair values of their individual reporting units and the company's total market capitalization. We would expect the extent of documentation and detail of analysis to vary based on facts and circumstances.

The SEC staff has said it does not expect a registrant to determine its market capitalization using a point-in-time market price as of the date of its goodwill impairment assessment.[9] Instead, the registrant may consider recent trends in its stock price over a reasonable period leading up to the impairment testing date.

Historically, a "reasonable period" has been interpreted to mean a relatively short period, the length of which might vary depending on the company's particular facts and circumstances. However, the SEC staff also has said that registrants should not ignore a recent decline in market capitalization. Companies should be prepared to support any range of dates used to determine their market capitalization, based on company-specific factors, including volatility in the company's stock price.

See section 3.3.1 (before the adoption of ASU 2017-04) or section 3A.3.1 (after the adoption of ASU 2017-04) of our FRD, ***Intangibles — goodwill and other***, for additional guidance.

Implied control premium

The fair value of a reporting unit is the amount at which the unit as a whole could be sold in a current transaction between willing parties (i.e., not in a forced sale, such as a liquidation). If a public company has only one reporting unit (or a company owns a publicly traded subsidiary that represents a reporting unit), the market capitalization of the public company (or its public subsidiary) provides significant evidence about the fair value of that reporting unit.

When the estimated fair value of a company is greater than its market capitalization, this generally implies that a control premium has been considered in determining the reporting unit's fair value. A control premium may be included if management believes that substantial value may arise from an acquirer's ability to take advantage of synergies and other benefits (e.g., enhanced cash flows, reduced risk) that result from its control over the company (or reporting unit). This difference between computed fair value and market capitalization occurs because shares in public companies trade on a non-controlling basis.

The SEC staff[10] has said that it does not apply a bright-line test and that the application of judgment can result in a range of reasonably possible control premiums. Regardless of whether the analysis is quantitative, qualitative or some combination of those approaches, the SEC staff has said it would expect the company to have objective evidence to support the reasonableness of its implied control premium. The SEC staff also expects the amount of documentation supporting the implied control premium to increase as the control premium increases.

When markets are volatile and there is a lot of uncertainty, the range of implied premiums may widen and the premiums themselves may rise. During the financial crisis of 2008, premiums in completed transactions increased significantly. When implied premiums increase, more analyses and documentation may be required to support the market capitalization reconciliation based on current market conditions, including those involving the following considerations:

- *Synergies* — the price that would be paid to obtain specific synergies that would enhance an enterprise's cash flow as a result of obtaining control

- *Reduction in required rate of return* — the increase in value from reducing the required rate of return through the market participant acquirer's ability to optimize the capital structure
- *Information transparency* — the difference between the information a market participant acquirer of the business as a whole would have access to and an individual who buys shares in the public market would have access to

Determining a reasonable implied control premium is often challenging. The Appraisal Foundation's ***Valuations in Financial Reporting Valuation Advisory 3: The Measurement and Application of Market Participant Acquisition Premiums*** (Valuation Advisory) that was issued in September 2017 provides best practices on the appropriate methodologies to use. Although the Valuation Advisory is not authoritative guidance, we understand that the valuation techniques described in the Valuation Advisory are generally recognized by the valuation community as acceptable methods for determining a control premium.

See section 3.3 (before the adoption of ASU 2017-04) or section 3A.3 (after the adoption of ASU 2017-04) of our FRD, ***Intangibles — goodwill and other***, for additional guidance on determining the fair value of a reporting unit when performing the goodwill impairment test.

When implied control premiums increase, more analyses and documentation may be required to support the reasonableness of the premiums.

How we see it

For an impairment test as of 31 March 2020, companies may consider pricing information during a reasonable period that includes the current economic conditions. However, stock prices during periods before the recent market declines would generally not be considered reflective of fair value as of the impairment testing date and should not be used in a market capitalization reconciliation.

Given the broad declines in share prices recently, companies will need to carefully evaluate the reasonableness of their implied control premium when reconciling the fair value of their reporting unit(s) to their market capitalization to corroborate their impairment analysis. The increase in implied control premium may provide evidence about the degree of uncertainty associated with anticipated recovery from current conditions that should be reflected as an adjustment to the PFI that is used in determining the fair value of the reporting unit.

Companies should carefully evaluate and document the underlying factors that contribute to the implied control premium.

Impairment disclosures

If an impairment loss is recognized, companies are required to disclose a description of the facts and circumstances that led to the impairment, the amount of the impairment loss and the method used to determine the fair value of the impaired intangible asset or reporting unit. For impaired intangible assets, companies are also required to disclose a description of the asset and the income statement caption or line item in which the impairment loss is recorded.

Companies should provide the following disclosures when appropriate:

- Reporting units that may be at risk of failing a future quantitative test
- The company's impairment testing policies, including when the quantitative and qualitative tests were performed, and how reporting units are identified and aggregated
- How the fair value of each reporting unit was estimated, including the significant assumptions (and the risks and uncertainties associated with them) and critical estimates used

How we see it

The SEC staff frequently asks for additional information about a registrant's impairment analysis, particularly when the future impairment of goodwill is a known uncertainty that a registrant must disclose in management's discussion and analysis. Among other information, registrants should consider disclosing when any reporting unit's estimated fair value does not substantially exceed its carrying value (i.e., the reporting unit is at risk of failing a future impairment test under ASC 350).[11] The SEC staff often requests this information when the registrant's operating results (or those of the relevant segment) have declined significantly. The assumptions and estimates disclosed by management are likely to evolve as conditions change.

Next steps

With the end of the first quarter approaching for calendar year-end public companies, audit committees, boards and executive management should be thinking about impairment.

Companies should engage with their auditors or business advisors as soon as possible to discuss how the economic fallout from the pandemic is affecting their business and related financial reporting, including the impairment assessment for goodwill and indefinite-lived intangible assets.

Endnotes:

1 ASC 360-10-35-26 through 35-27 and ASC 350-20-35-31 through 35-32.

2 ASC 350-30-35-4 states that "the useful life of an intangible asset is indefinite if that life extends beyond the foreseeable horizon — that is, there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of the reporting entity." See section 2.1 of our FRD, ***Intangibles — goodwill and other***, for further guidance.

3 ASC 350-30-35-21.

4 Goodwill is a residual amount calculated as the excess of the acquisition-date fair value of consideration transferred (including the fair value of any noncontrolling interest and any equity interest previously held by the acquirer in the acquiree) over the acquisition-date fair value of the identifiable net assets acquired.

5 Private companies and not-for-profit entities that elect to adopt the Private Company Council (PCC) accounting alternative for the subsequent measurement of goodwill amortize goodwill and apply a simplified one-step impairment test. See appendix A of our FRD, ***Intangibles — goodwill and other***, for further information.

6 Private companies and not-for-profit entities that elect to adopt the PCC accounting alternative for the subsequent measurement of goodwill may elect to test goodwill for impairment at either the entity or reporting unit level. See section A.3.1 of our FRD, ***Intangibles — goodwill and other***, for further information.

7 ASC 820-10-35-24B states, "In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or a liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, that might be the case when valuing a reporting unit)."

8 The American Institute of Certified Public Accountants (AICPA) Guide, *Prospective Financial Information*, defines PFI as "any financial information about the future. The information may be presented as complete financial statements or limited to one or more elements, items, or accounts. Prospective financial information can be either a forecast or a projection."

9 Remarks by Robert G. Fox III, Professional Accounting Fellow at the SEC, at the 2008 AICPA National Conference on Current SEC and PCAOB Developments, 8 December 2008.

10 Remarks by Robert G. Fox III, Professional Accounting Fellow at the SEC, at the 2008 AICPA National Conference on Current SEC and PCAOB Developments, 8 December 2008.

11 Financial Reporting Manual Section 9510.3 provides a list of items that registrants should consider disclosing for each reporting unit that is at risk.