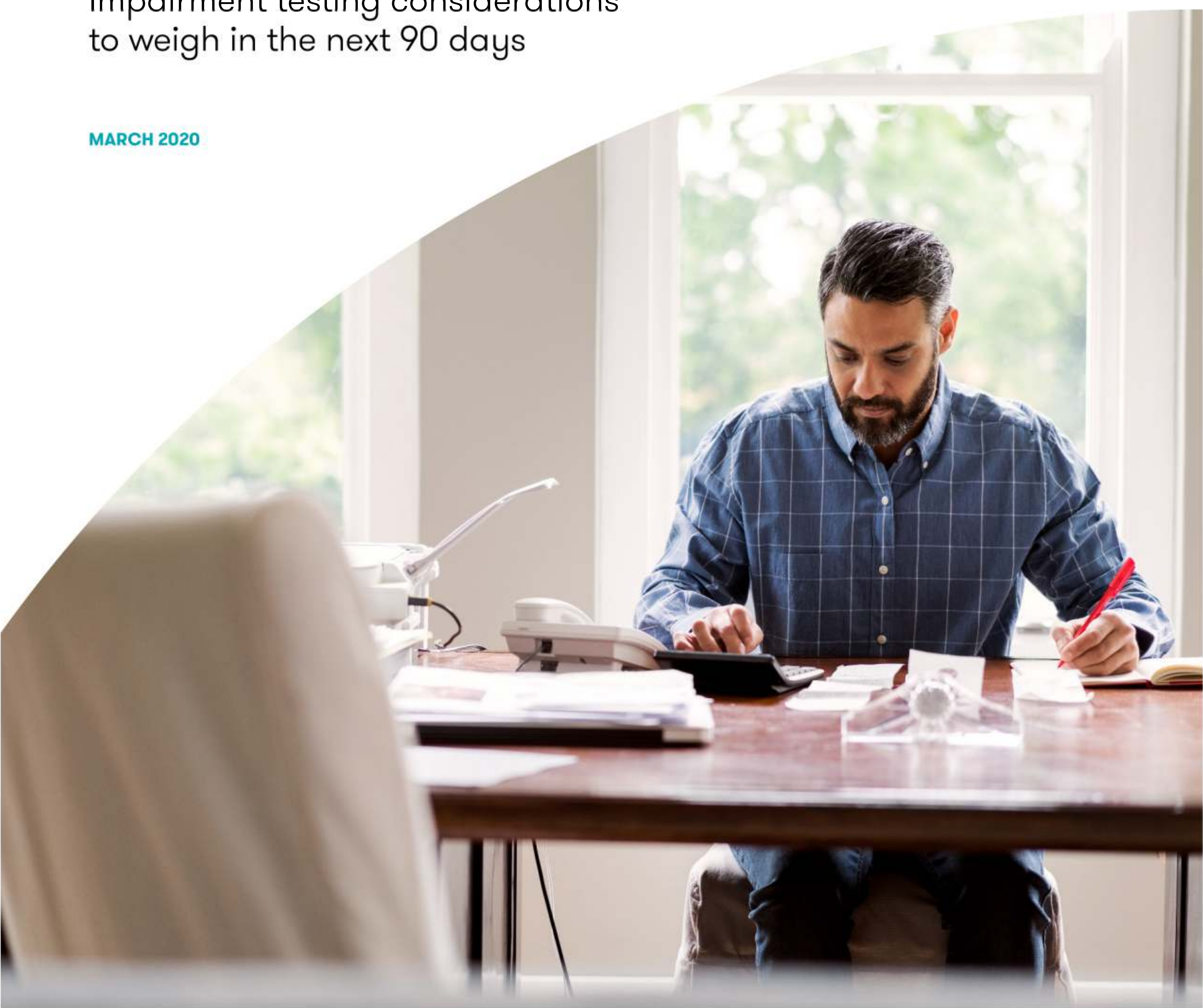
Reducing financial risk for pandemic resiliency

Impairment testing considerations to weigh in the next 90 days

MARCH 2020



Adjusting to new challenges

The pandemic recession has added complexity and urgency for impairment testing considerations

Act now to safeguard shareholder trust and value

The outbreak of the Novel Coronavirus (COVID-19), declared by the World Health Organisation as a "Global Pandemic" on March 11, 2020, has impacted global financial markets. Travel restrictions have been implemented by many countries. Market activity is being impacted in many sectors. For future impairment and other valuations we believe that we can attach less weight to previous market evidence for comparison purposes, to inform opinions of value. Indeed, the current response to COVID-19 means that we are faced with an unprecedented set of circumstances on which to base a judgement. Subsequent valuations will therefore be reported on the basis of "material valuation uncertainty." Consequently, less certainty – and a higher degree of caution – should be attached to valuations than would normally be the case. Given the unknown future impact that COVID-19 might have, we recommend that you keep valuations under frequent review. This is similar to the valuations performed during the 2008-2009 financial market crisis.

The stock market crash triggered by COVID-19 will have many companies looking at their current stock price and wondering if it is an ASC 350 (goodwill and other intangible assets) and ASC 360 (property, plant and equipment) impairment triggering event. We have summarized some of the special considerations in determining fair value estimates, including impairment charges.

While companies grapple with urgent issues related to their people, liquidity, cash flow management, supply chain and customer demand, many are at risk for missing a potential trap in impairment testing. Timing, appropriate methodology in writing down assets, and proper documentation are the teeth of this trap.

If impairment testing is not performed at the right time and in the right way, the consequences can be painful. In a worst case scenario, misstatements can leave companies open to litigation for fraudulent conveyance as stakeholders question whether or not they were misled.

The impairment test needs to be completed and recorded by the end of the quarter that the triggering event occurs.

From an economic standpoint, share prices have declined severely and short- to mid-term financial performance expectations have become less certain for both public and private companies. We anticipate that the valuation issues in the current COVID-19 economy are likely to be similar to those that we experienced during the 2008-2009 financial crisis.

Now is the time for companies to gain sure footing around triggering event guidance, documentation and testing that may need to be performed very soon.

RESILIENCY STARTS WITH A COMMITMENT TO IDENTIFY AND MITIGATE RISK FACTORS THAT CAN FURTHER DISRUPT YOUR BUSINESS.

Answers to common questions

Arming you with the knowledge you need for the current crisis

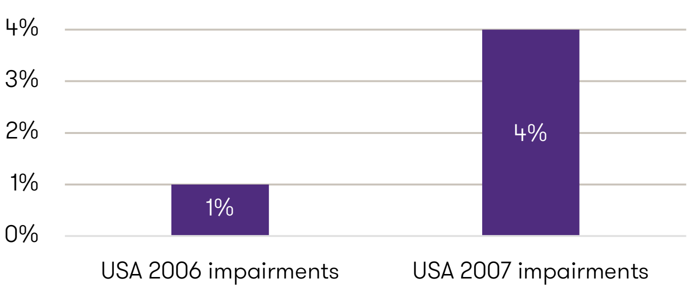
TRIGGER EVENT
My share price has declined but we are confident it will recover in due time. The current price of our shares are not rational, therefore this should not be a trigger event and a requirement for impairment testing, right?

One cannot state the dip in the stock markets and price, overall decline in the economy, and declines in expected future cash flows are only temporary and may recover in short order.

The percentage of S&P 1200 companies that had a market capitalization less than their book equities increased during the financial crisis in 2009. See the two charts below. This could happen again in the current environment.

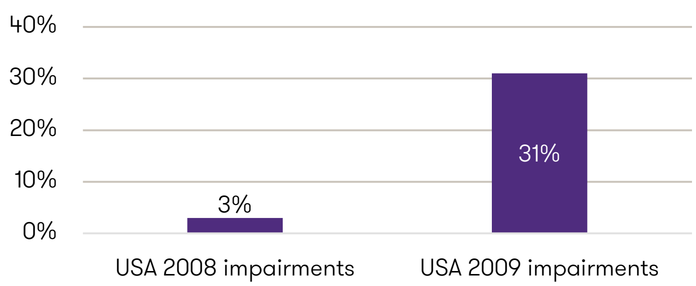
Before crisis

United States impairments*



During crisis

United States impairments*



*sourced from Capital IQ Database

It's more than just share price drops

Of course this depends on a number factors. FASB ASC 350-20-35-30 states that "[g]oodwill of a reporting unit shall be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount." The following items from ASC 350-20-35-3C are examples of such events.

- **Macroeconomic conditions** such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets.
- **Industry and market considerations** such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development.
- **Cost factors** such as increases in raw materials, labor or other costs that have a negative effect on earnings and cash flows.
- **Overall financial performance** such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods.
- **Other relevant entity-specific events** such as changes in management, key personnel, strategy or customers; contemplation of bankruptcy; or litigation.
- **Current stock market volatility** has been as dramatic as in the 2008-2009 financial crisis. This is not a factor listed in ASC 350-20-35-3C but was a issue in impairment valuations then. It affected interest rates and inputs to the derivation of the weighted average cost of capital and market multiples used in ASC 350 valuations. This is likely to occur in current ASC 350 valuations. The 2006-2007 and 2008-2009 volatility is presented in Appendix A.

- **Events affecting a reporting unit** such as a change in the composition or carrying amount of its net assets; a more-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit; the testing for recoverability of a significant asset group within a reporting unit; or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.
- **If applicable, a sustained decrease in share price** (consider in both absolute terms and relative to peers).

We are certainly observing decreases in share prices. The concept of a sustained decrease is not defined in accounting literature, so an element of judgment is required to determine whether this criteria is satisfied. If current market conditions are not suggestive of a pending recovery in share price, that condition may be suggestive of sustained decrease. Note that the impairment guidance does not embrace the concept of "other than temporary." That is, if a sustained decrease in share price is present, it is not mitigated by a claim that the decline is temporary. Note also that the share price generally is representative of all information available to market participants (i.e., semi-strong condition). Therefore if a company is in possession of non-public or asymmetrical information, this information may be considered in the determination of fair value relative to market pricing.

Note also that the timing of this determination is critical to public registrants due to quarterly reporting requirements.

CONTROL PREMIUM

What about a control premium? Isn't that allowed in ASC 350?

Documentation determines viability

Since the unit of account in a goodwill impairment test is at the reporting unit level, it's fair value is implicitly on a control basis. As such, the guidance in ASC 350 20-35-35-23 provides "(s)ubstantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity. Consequently, measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity's individual equity securities. An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest." This may cause the sum of the reporting units' fair value to be greater than the company's market capitalization.

In reconciling the sum of the reporting units' fair value to the company's market capitalization, one might have to apply and support a control premium to the company's market capitalization.

Thus judgement and documentation is required. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit. Control premiums were higher in the 2008-2009 financial crisis than before it.

Before crisis

U.S. 2006-2007: Control premium (%)

	1 day prior	1 week prior	1 month prior
Median	23.28%	26.09%	29.41%
Mean	29.84%	31.11%	45.47%

During crisis

U.S. 2008-2009: Control premium (%)

	1 day prior	1 week prior	1 month prior
Median	34.91%	39.28%	35.82%
Mean	36.61%	38.72%	45.47%

The implied premium relative to market cap should be assessed for reasonableness relative to observable external data. The comparison may be completed at either the equity or enterprise level. Note that the higher the premium, the more complete the documentation will need to be. Implied premiums to market capitalization above the upper bound are difficult to support absent unique facts and circumstances.

As indicated earlier, the 2008-2009 control premiums were higher during the recession. In the ASC 350 reconciliation of the market cap to the sum of the reporting units' fair values, it was necessary to use high control premiums. A COVID-19 economy valuation may require the same higher premiums. Judgement and documentation will be required in supporting them when your auditors review the ASC 350 valuation.

U.S. 2018-2019: Control premium (%)

	1 day prior	1 week prior	1 month prior
Median	20.68%	22.43%	21.91%
Mean	26.25%	27.42%	28.10%

APPLICABILITY TO PRIVATE COMPANIES
Does this process apply to private companies? What if we made the private company election to amortize goodwill?

Applies, even to those who amortize goodwill

There is no distinction between private and public companies as it relates to trigger events and any resulting impairments. There are generally no quarterly reporting requirements for private companies so care must be taken in making this determination at the appropriate date. Although there is no share price to observe, note that many of the other events may be present irrespective of the lack of share price. The impairment rules still apply if a company has made the private company election to amortize goodwill. Note also that the potential for impairment may not be as severe since goodwill will have been amortized over time, resulting in a lower carrying amount for testing purposes.

ASC 360
What do I need to know about application of ASC 360?

ASC 360 considerations

The first step in preparing the ASC 360 impairment analysis is to first determine the proper level of testing. You should perform the test at the lowest level below the reporting unit where future cash flows are independent from the use of other assets and can be readily measured. Sometimes this may result in testing at the reporting unit level or may be at some other lower component level such as a building level or a store level.

The first test is to determine if there has been a triggering event. If a triggering event has occurred, you would measure the undiscounted cash flow over the remaining useful life of the primary asset of the asset group. The primary asset should not include an indefinite lived asset. You would then compare the undiscounted cash flow (inclusive of the residual value of the asset group) to its carrying amount. If you are testing at the reporting unit level, you would include goodwill in the carrying amount. If testing at a level below the reporting unit level you would exclude goodwill in deriving your carrying amount.

The cash flows used in this analysis would not typically be the same cash flow used in the ASC 350 impairment test because you are measuring recoverability of the existing group of assets and would typically exclude expansion and use of new assets that may be permitted in the ASC 350 analysis. It would not assume capital expenditures that may be required to expand production capacity to fuel future revenue growth objectives.

If you fail the recoverability test, you complete the fair value of the asset group and compare it to the carrying amount. If the fair value is below the carrying amount, you allocate this deficit pro-rata based on relative carrying amounts to each of the long-lived assets excluding goodwill and other indefinite life assets. However, you should not write down the long-lived assets below the fair value of the individual asset.

OTHER FACTORS
What other factors should be considered?

Sequence of testing process with interdependencies

Note there is an interdependency among indefinite-lived intangible assets (ILIAs), long-lived assets and goodwill. There is a hierarchy to the testing process that takes the following sequence.

1. ILIAs under FASB ASC 350 where the amount of impairment, if any, is recorded prior to proceeding to;
2. Long-Lived Assets under FASB ASC 360 where the amount of impairment, if any, is recorded prior to proceeding to;
3. Goodwill under FASB ASC 350

If a company determines that they must conduct a quantitative test, a determination is required as to the structure of the transaction modeled in the step one test. It may either be modeled as a sale of assets (taxable) or a sale of stock (non-taxable). Each of these generally yields a different answer depending on the amount of tax attributes involved as well as the magnitude of basis differential between book and tax. This determination is critical as the fair value of the reporting unit determined in step one has a direct dollar-for-dollar impact on the ultimate impairment recognized. If the company models the transaction as a taxable sale it must document why this is reasonable. The company may have a history of only structuring its acquisitions or divestitures as taxable deals, or taxable deals may be the primary structure within its industry.

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Additional insights for pandemic resiliency

Drastic changes to working arrangements around the world and ever-changing expectations of customers, employees and governments mean it's time to examine a variety of risks. We can help you address four key impact zones in order to increase revenue and decrease expenses, thereby positioning you to return to growth.

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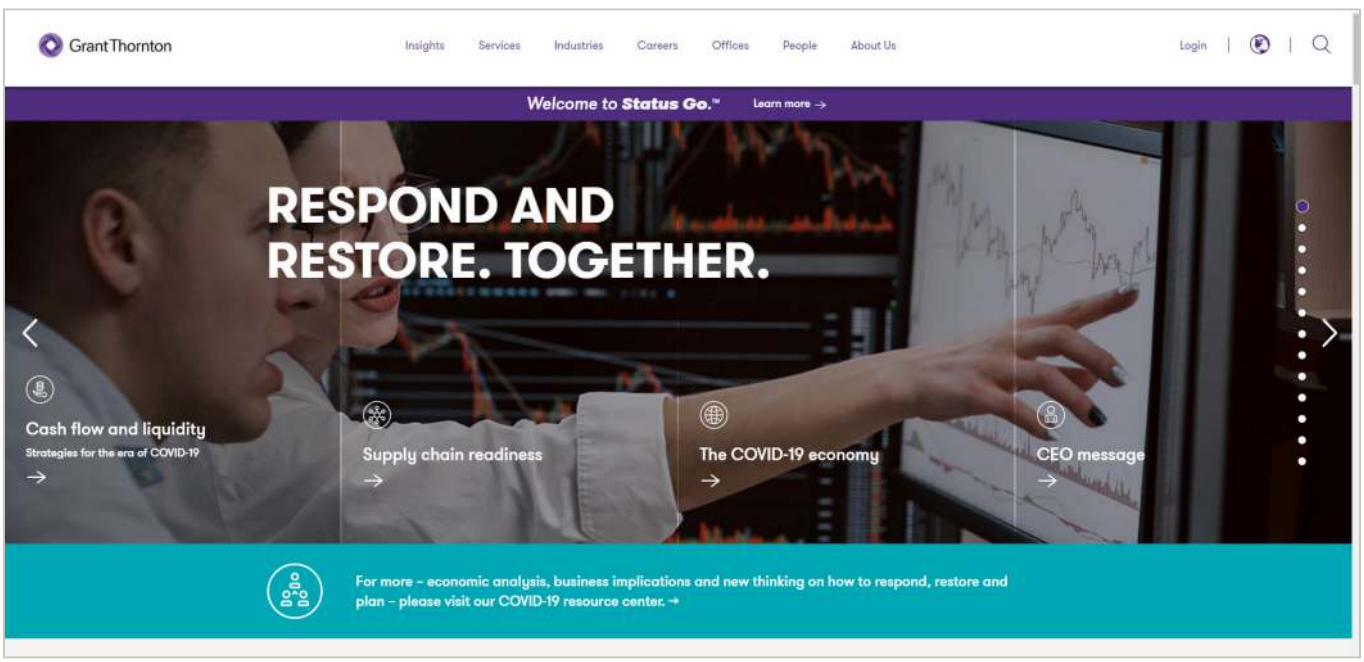
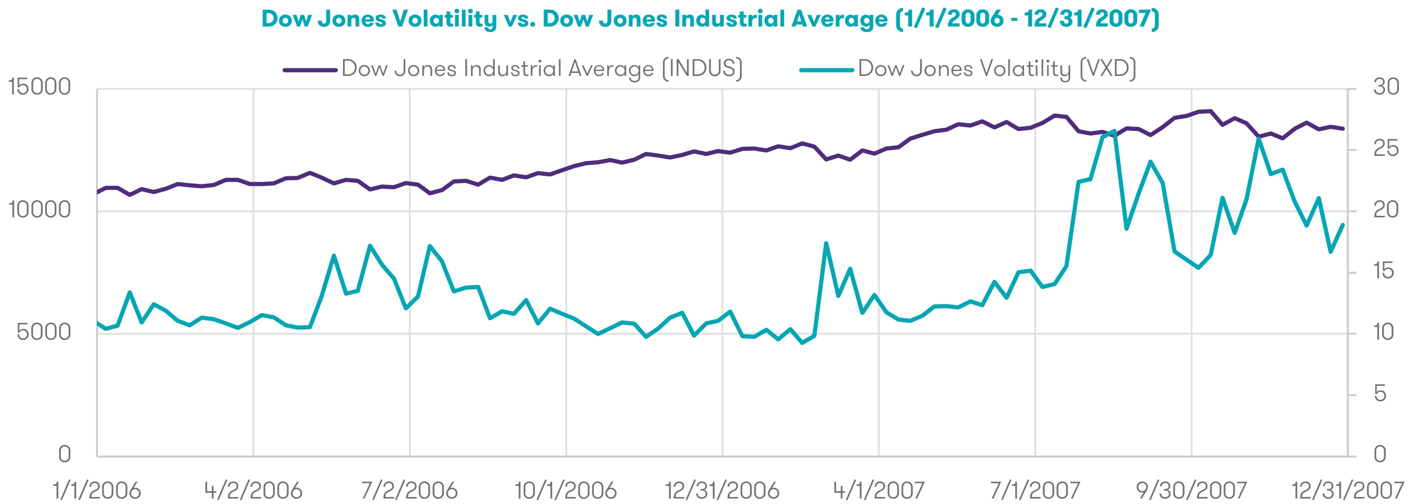


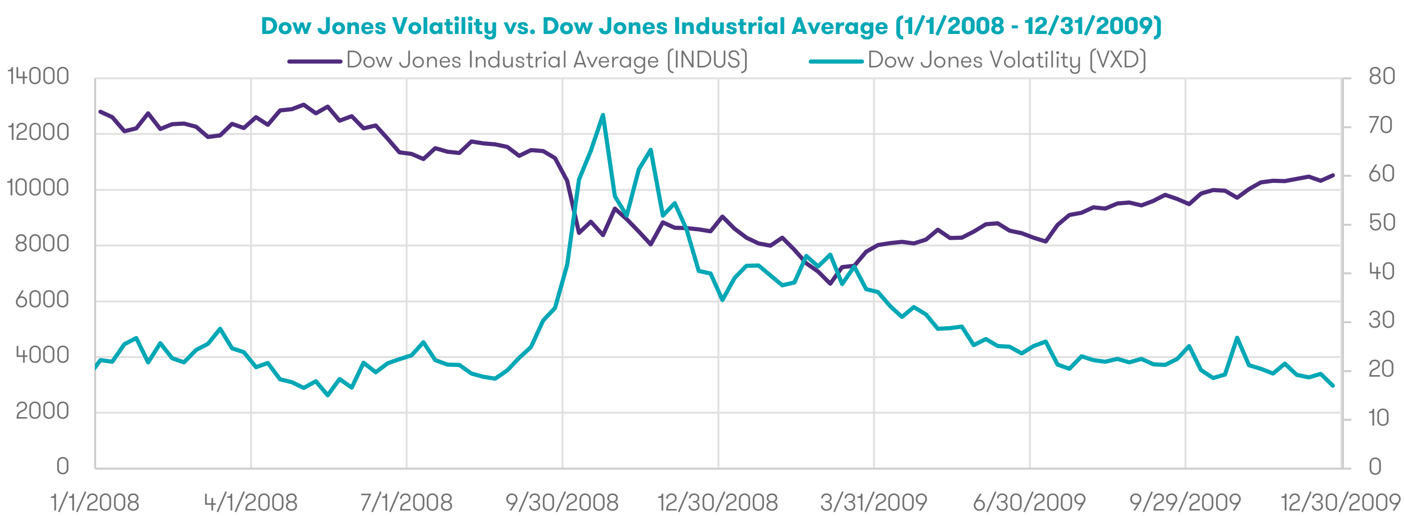
Appendix A – Stock market volatility

The high volatility in the 2008-2009 market impacted interest rates and inputs to the derivation of the weighted average cost of capital and market multiples used in impairment and other valuations during this time. It could have the same impact in current COVID-19 period valuations.

Volatility before crisis



Volatility during crisis



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