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Should The Criteria Used to Determine the Recognition of an Impairment Loss
Depend on the Asset in Question?

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Should The Criteria Used to Determine the Recognition of an Impairment Loss Depend on the Asset in Question?

Generally accepted accounting principles require that the carrying amounts of most current assets be assessed and written down, if necessary, at each balance sheet date.¹ Although more complex, why should long-term assets be treated differently? The Financial Accounting Standards Board agreed that they should not, so in March 1995, the board issued Statement Number 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of" which provided the first authoritative guidance for the write-down of long-term assets. For more than a decade prior to its issuance, due in part to the inequity between current and long-term assets, impairment practices were diverse and thus, accountants sought guidance on this issue.²

Now that the FASB has given practitioners the guidance they have requested in the form of Statement 121, there are still issues which bear discussion. One of these, "should the criteria used to determine the recognition of an impairment loss depend on the asset in question," will be addressed in this seminar paper. Several aspects will be discussed, specifically the presence of unique triggering events, the judgment involved in grouping assets together, the role of goodwill, the effect of various exemptions given by SFAS

¹ Booker, Quinton. "SFAS No. 121 Illustrated." National Public Accountant 41.2 (1996): 26.

² Ibid.

121, the calculation of cash flows, and the intent of the entity with respect to the asset. The objective of this study is to confirm that the criteria used to determine the recognition of an impairment loss should, in fact, depend on the asset in question.

Mechanics of SFAS 121

Before studying the interaction between criteria and devaluation, it is important to understand the mechanics of SFAS 121. First of all, the primary objective of SFAS 121 is to standardize the practice of asset write-downs and supply guidelines on determining when carrying amounts have declined permanently and substantially.³ The result is a two-step process for determining whether impairment is appropriate and, if so, by what amount. First, the carrying amount of the asset is compared to the net undiscounted future cash flows without interest charges expected from the asset's remaining use and disposition. For any asset that has a carrying amount which exceeds these net future cash flows, the entity must compare the carrying amount to the asset's fair value. If the carrying value exceeds the fair value, the asset is impaired—an impairment loss is recognized for the difference and the asset is reduced to fair value. From the time that the impairment is recognized, the asset will be listed at the new carrying value on the balance sheet.⁴ The following example may be helpful in understanding the impairment process:

³ Op.cit.

⁴ Statement No. 121: Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of. Mar. 1995. Internet:
[Http://www.rutgers.edu/Accounting/raw/fasb/st/summary/fas121.htm](http://www.rutgers.edu/Accounting/raw/fasb/st/summary/fas121.htm)

The recent construction of a new baseball stadium across town indicates a reduced demand for a parking lot owned by ABC Company. ABC Co. suspects that the lot may need to be impaired. First, the carrying (or balance sheet) amount is compared to the future undiscounted cash flows from the eventual use and disposition of the lot, as shown:

<u>Carrying Amount</u>	<u>Future Cash Flows</u>
\$50,000	\$30,000

Since the carrying amount exceed the future cash flows, ABC is required to compare the carrying value to the fair market value of \$25,000. The determination that the carrying amount exceeds the fair market value leads to the recognition of an impairment loss of \$25,000 (Carrying amount less FMV).

Triggering Events

It is important to note from the previous example that the review of assets for impairment loss is not periodic. Required periodic assessment of all long-term assets would be time consuming and expensive. Here the FASB made a practical ruling and determined that an assessment need only be made if information suggests that carrying amounts may not be recoverable. The FASB did provide broad examples to aid practitioners, but this list is certainly not exhaustive:

- a significant decrease in the market value of an asset;
- a significant change in the extent or manner in which an asset is used or a significant physical change in an asset;

- a significant adverse change in legal factors or in the business climate that affects the value of an asset or an adverse action or assessment by a regulator;
- 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 an asset; and
- an accumulation of cost significantly in excess of the amount originally expected to acquire or construct an asset.⁵

However, these examples are very broad and do not provide the context specific examples needed to examine assets on a case-by-case basis. In contrast, there are “triggering events” that are unique to specific assets or industries. For example, the Department of Housing and Urban Development suggests the following events which affect their business but are not accounted for in the FASB Statement:

- Mortgage payments in arrears
- Delinquent deposits to asset replacement and residual receipts reserves
- Negative surplus cash position
- Substantial need for repairs and replacement of assets.⁶

In situations such as this, the entity must be vigilant for change in its environment which may indicate the need for a review and assessment of a specific asset or group of assets. This is especially important considering the

⁵ Applying GAAP and GAAS. New York: Mathew Bender & Co., Inc., 1996.; FASB also cites the AICPA Issues Paper “Accounting for the Inability to Fully Recover the Carrying Amounts of Long Lived Assets” which provides additional examples.

⁶ Hoffman, Gary S., CPA. “Impairment Standard Affects Audits of HUD Properties.” The Practicing CPA Jan 1997. Internet: <http://www.aicpa.org/pubs/tpcpa/jan97/isaahudp.htm>

wide range of unique criteria which may signal an assessment.⁷ However, the mere existence of a triggering event does not necessarily mean that the entity must recognize an impairment loss—only that a formal review of the asset's value must be undertaken, as shown in the following example:⁸

If a company has just installed a computerized operating system for its manufacturing plant, it is likely that the fair value of the computer system is significantly less than its capitalized cost. Nonetheless, if the manufacturing plant will generate sufficient cash flows to recover the cost of the asset, there is no impairment loss to recognize.⁹

Asset Grouping

Another criterion which may signal an impairment is the formation of an asset group. SFAS 121 states, "in estimating future cash flows, assets should be grouped at the lowest level for which there are identifiable cash flows largely independent of other assets."¹⁰ In other words, assets may be grouped when they are used together to produce joint cash flows consistent with management's method of operating assets.¹¹ The following two examples illustrate the way grouping affects the recognition of impairment losses.

⁷ Applying GAAP 10-68.

⁸ Ibid, 10-72.

⁹ Ibid, 10-73.

¹⁰ Statement 121.

¹¹ Nurenberg, Hugo, and Dittmar Nelson, Jr. "Auditing Considerations of FASB 121." Journal of Accountancy 182.1 (1996): 71-75.

The first example, taken from Grant Thornton LLP's *Manufacturing and Distribution Issues* is a general example.

Suppose you have two plants with identical equipment in two different locations. One is profitable and one isn't. Your assets may not be impaired in the unprofitable location. Start-up costs, wage differential, different market conditions—a wide variety of issues could account for the disparity. However, SFAS 121 requires that assets be grouped at the lowest level for which there are independent cash flows. In the two-plant example, the operations may be so intertwined that the two plants must be grouped together, thereby producing sufficient cash flow.¹²

The second scenario which demonstrates the power of grouping is a much more specific look at the way grouping affects the bottom line of companies—specifically in the oil industry:

Among the hardest hit by the rule are oil companies, because 121 requires that assessment be made at the lowest level at which cash flows can be separately identified, such as a single oil field. Until now, most oil companies valued assets such as oil fields on a country-by-country basis, a system in which a profitable field would balance less profitable ones. Texaco Inc. took a \$640 million charge as a result of the

¹² "SFAS 121 Reviews Could Result in Operational Insights, Tax Savings." Grant Thornton, LLP: Manufacturing & Distribution Issues. Summer 1996: Internet: <http://www.gt.com/gtonline/mandist/issues/mdism96f.html>

ruling. "It took our earnings from \$367 million down to negative \$251 million for the quarter. . ."13

These two scenarios exemplify the far-reaching effects that asset grouping has on the recognition and calculation of impairment losses and thus the reasoning behind giving serious consideration to this criterion with respect to individual assets.

Goodwill

In many situations, the presence of goodwill must be taken into account. SFAS 121 applies to tangible and certain identifiable intangible long-lived assets such as patents and copyrights.¹⁴ There are three main ways that these assets involve the recognition of impairment losses. First, a very important point to remember is that before reducing identifiable assets' carrying amounts, any and all goodwill that relates to an asset or group of assets must be written down to zero.¹⁵ Secondly, the rule applies only to goodwill that has been purchased in combination with a business. In this case, any recorded goodwill must be evaluated as a part of the asset group in question. Again, any goodwill must be written down to zero before an impairment may be recognized.¹⁶ Finally, any goodwill that is not related to impaired assets should continue to be accounted for under APB 17, "Intangible Assets," which does not give a specific

¹³ Cahill, Kathleen. "Impaired Assets: The Bottom Line." CFO April 1996: 11.

¹⁴ Booker 41.

¹⁵ Applying GAAP 10-70.

¹⁶ Booker 41.

method for calculating goodwill.¹⁷ The combination of these three situations involving goodwill evidences the fact that goodwill must be analyzed as a criterion, but that the angle from which it is analyzed depends upon the asset under examination.

SFAS 121 Impairment Exemptions

Another important area for consideration when assessing a long-lived asset for impairment loss is its exemption status. SFAS 121 identifies numerous long-lived assets as exempt from its reaches:

- financial instruments;
- long-term customer relationships of financial institutions (such as core deposit intangibles and credit card holder intangibles);
- mortgage and other servicing rights;
- deferred policy acquisition costs; and
- deferred tax assets.

Additionally, there are five issues which are covered by other FASB statements which are not superseded by No. 121 (Statement Nos. 50, 53, 63, 86, & 90). Finally, there are two Statements—No. 66 “Accounting for the Sale of Real Estate” and No. 67 “Accounting for Costs and Initial Rental Operations of Real Estate Projects”—which are amended by SFAS 121. All assets should be examined separately to be sure that they do not qualify for exemption under SFAS 121.¹⁸

¹⁷ Applying GAAP 10-70.

¹⁸ Applying GAAP 10-75.

Cash Flow Calculation

The fifth category in this paper deals with the calculation of cash flows from step one in the analysis process. Following are three specific areas in which the method of calculation of cash flows may affect the recognition of, or the amount of, impairment loss per asset. Some practitioners believe that the procedures followed in testing for and measuring impairment should be changed to include certain deferred assets and accrued payables related to real estate properties. They argue that liabilities such as deferred leasing commissions, unbilled rent, and accrued environmental contamination costs are expected to be recovered from the future cash flows of the property. Thus, excluding these could unfairly state the amount of the loss or avoid a loss completely. The FASB staff concludes that SFAS 121 is flexible and allows for the modification of cash flows to limit misleading results.¹⁹

A second means of the use of cash flows that may be unique to specific assets are the effects of environmental exit or site restoration costs. For certain assets, such as mines and landfills, costs for the future restoration or closure of certain sites may be incurred if management sells, abandons, or ceases operations of an asset.

The question raised is whether or not these future costs that have been recognized as liabilities should be included in the undiscounted cash flows to test for impairment. The consensus of professionals is that these costs should

¹⁹ Haspel, Abraham. "Implementing SFAS No. 121 for the Impairment of Real Estate." The CPA Journal 66.7 (1996): 36-41.

be excluded from the undiscounted cash flows used to test for recoverability because they depend heavily upon management's intentions.²⁰ If the costs have not been recognized as liabilities, then they may be either included or excluded from the cash flow test based upon the specifics of the asset and the situation.²¹ These two examples show how the cash flows and the amounts contained therein must be evaluated on a case by case basis and a consensus reached before impairments can be tested for in a reasonable manner.

Intent of Management

The final and most conclusive point to be stressed in this paper relates to the measurement of impairment losses in two cases: assets held for use and assets held for disposal. When one determines the impairment loss for an asset held for use, the two-step process presented in the mechanics section of this paper should be followed.²² On the other hand, when the asset in question is to be disposed of (but is not considered a discontinued operation), the assets are to be reported at the lower of carrying amount or fair value less costs to sell. Furthermore, the impairment losses for assets held for use are non-recoverable. However, losses recognized for assets held for disposal may be recovered, although the recovery may not exceed the total impairment loss.²³ If, by chance, the asset can be classified as a discontinued operation, then

²⁰ Applying GAAP 10-74.

²¹ Ibid.

²² Op.cit, 10-71.

²³ Applying GAAP 10-77.

SFAS 121 does not apply and the asset is governed by APB Opinion No. 30, "Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions."²⁴ As these examples show, the correct classification and treatment of an asset as held for use, held for disposal, or as a discontinued operation is extremely important in calculating a reasonable amount of impairment loss and must be classified on a case-by-case basis.

Conclusion

In conclusion, SFAS 121 gives authoritative guidance to those practitioners who must deal with long-lived assets. The Statement provides the methodology necessary to recognize and calculate impairment losses. However, using sound judgment and taking into account a wide range of criteria to properly assess each individual situation is still necessary. Six of the criteria which may be taken into account have been presented in this paper. Each gives cause to analyze each situation carefully while keeping a specific asset in mind. Each also provides cause to give much thought to what treatment the individual asset or group of assets may require.

²⁴ Statement 121.

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