COVID-19 impact on long-lived assets

COVID-19 is significantly affecting fair values of long-lived assets. Now is the time to evaluate the impact of COVID-19 on long-lived assets. **KPMG can help**.

Given the current economic climate, many companies may need to evaluate the recoverability of goodwill; intangible assets; property, plant, and equipment; and lease right-of-use (ROU) assets. The impairment testing for long-lived assets (e.g., property, plant, and equipment; finite-lived intangible assets; and lease ROU assets) is trigger based and often misunderstood. We have prepared this document, which summarizes the key elements of the testing process, to assist companies facing potential long-lived asset impairments.

Understand what constitutes an impairment loss and a triggering event

An impairment loss may exist if the carrying amount of the asset (asset group) exceeds the sum of the estimated undiscounted future cash flows from the use and eventual disposition of the asset group. If, in addition to this, the carrying amount of the asset (asset group) exceeds its fair value, an impairment exists, and the impairment loss is measured as the amount of the excess.

Triggering event examples: The following are examples (not exhaustive) of events or circumstances that suggest a possible impairment of long-lived assets, some of which resonate in the current environment.

Market price	A significant decrease in the market price of a long-lived asset (asset group)
Changes in asset use	A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or change in its physical condition
Changes in legal factors/ business climate	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
Cost factors	An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)
Financial performance	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)
Events affecting an asset's use	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

Do we expect companies to have a triggering event?
It depends. In the current environment, we expect companies to have a robust process for identifying triggering events. Now is the time to evaluate the impact of COVID-19 on long-lived assets.

Step 1: Perform a recoverability test

As Step 1, a recoverability test is performed by comparing the carrying amount of the asset group to the sum of the estimated undiscounted future cash flows from the use and eventual disposition of the asset group. If those undiscounted cash flows are less than the carrying amount of the asset group, the entity then proceeds to determine the fair value of the asset group (Step 2 fair value measurement test) and recognizes an impairment loss if the carrying amount exceeds fair value. Estimates of future cash flows under the recoverability test should be based on the **entity's own assumptions about its use of the assets in the group**.

How does a company determine undiscounted cash flows for an asset group in the current environment?
Due to the uncertainties in the current environment, we expect companies to adjust the projected cash flows used in their recoverability tests and fair value estimates. The cash flows should be updated for known or expected events, such as the loss of a significant customer or tenant. Cash inflows should include future revenues and expected proceeds from disposal (they should not include revenue from enhanced service potential). Cash outflows should only include capital expenditures to maintain existing service levels, not to enhance or augment output or useful life.

Should a company consider new conditions arising after the impairment testing date when evaluating whether a long-lived asset group is impaired?
No. As the COVID-19 situation progresses and information evolves, a company should evaluate whether it relates to new conditions or circumstances that existed at the evaluation date. Estimates of cash flows and asset values for purposes of testing long-lived assets for recoverability should be based on conditions that existed at the evaluation date without using hindsight.

Step 2: Determine fair value

If the asset group fails Step 1 (sum of the undiscounted cash flows is less than the carrying amount), it would be necessary to move to Step 2, where the **fair value** of the asset group is determined based on **market participant assumptions**. Topic 820, *Fair Value Measurements,* defines fair value as "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."

Topic 820 states that the reporting entity must consider the highest and best use for a nonfinancial asset or group of assets. A fair value measurement of a nonfinancial asset takes into account a market participant's ability to generate economic benefits by using the asset at its highest and best use or by selling it to another market participant that would use the asset at its highest and best use. In considering the measures of fair value produced using the different techniques, an entity should consider the reliability of the valuation techniques employed and the inputs used in the valuation techniques.

The amount by which the asset group's carrying amount exceeds its fair value is its indicated impairment loss. However, no individual long-lived asset in the asset group may be written down below its fair value, including ROU assets.

How should the fair value of an ROU asset be determined?

The fair value of an ROU asset should reflect the amount that a market participant would be willing to pre-pay to obtain the ROU asset (i.e., the right to use the underlying asset for the remainder of the accounting lease term). Unlike traditional real estate assets, ROU assets are rarely transacted in the marketplace on a stand-alone basis. As a result, the fair value of an ROU asset needs to be determined through other methods. One method is to project out market rent over the remaining lease term and discount the market rent utilizing an appropriate discount rate.

To determine the appropriate market rent for the ROU asset (for impairment purposes), it is important to:

- Identify the appropriate market participant (lessee versus investor) and the principal market (if applicable) to identify the highest and best use of the ROU asset to the market participant
- Consider the as-is nature of the ROU asset:
  - Lease term: Market rent should reflect a rate commensurate with the remaining accounting lease term (i.e., the lease term reflected in the lease liability and the ROU asset), not the original lease term or solely the stated noncancelable lease term in the contract. The market rent should be projected over the accounting lease term.
  - Lease incentives: Consider the impact of rent concessions on the market rent obtained from the market and adjust accordingly.
  - Tenant improvements: Consider the utility that existing tenant improvements may have to a market participant and the impact on the market rent. Furthermore, to the extent tenant improvements are included in the asset group with the ROU asset, the market rent should not consider any value a market participant would ascribe to the in-place tenant improvements when valuing the ROU asset.
  - Available options or renewals: Consider the effect of available options to renew or extend the lease at the end of the accounting lease term, or to gain the incumbent lessee position for desirable locations, when evaluating the market participant and market rent.
  - Lease up costs and downtime: Consider lease up costs and downtime if the identified market participant is an investor; assume there are neither lease up costs or downtime if the identified market participant is a lessee.
  - Sublease restrictions: Consider the impact that a sublease restriction would have on the principal market and amount a market participant would be willing to pre-pay for an ROU asset.
  - Discount rate: The discount rate to present value market rent should be based on a market derived discount rate as opposed to utilizing the discount rate for the lease (typically, the lessee's incremental borrowing rate).

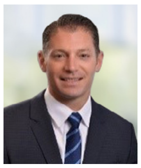
KPMG is here to help

Refer to https://frv.kpmg.us and https://tax.kpmg.us/services/valuations.html for additional guidance.

We understand choosing an adviser that has the technical skills and practical experience to provide sound and objective advice is of utmost importance during these uncertain times. KPMG professionals have experience in dealing with the challenges faced by market participants in such volatile times and can help you think through complex valuation topics and associated financial reporting implications.

Our experience working with a wide range of real estate developers, public REITs, private equity investors, and other market participants with significant real estate holdings provides us with an informed understanding of market dynamics and investor return requirements.

Contact us



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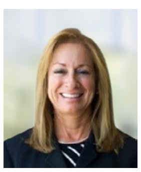

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