COMPLIANCE WEEK
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Squeezing Cash Flow From Impairments

By Tammy Whitehouse — May 5, 2009

Companies that are writing down values for their long-lived assets—and with the economy the way it is these days, who isn't?—should be looking for ways to wring some cash flow out of those impairments.

Companies are never happy about recording impairments, certainly, but they can't avoid them either, says Jay Hanson, national director of accounting for McGladrey & Pullen. "We see lots of companies resigned now that values are down," he says. "When cash flows are down, they realize they have to do it."

But there may be some upside to all those writedowns, according to Hanson and other

financial reporting experts. Foremost, an impairment charge against a long-lived asset diminishes the related depreciation expense, which shows up annually as a charge against earnings-per-share. That means an impairment charge can accelerate depreciation—which, in turn, improves the bottom line in future periods.

"If it's bad, how much worse could it get?" Hanson says. "So you dump all the depreciation charges into one statement. If you're pushing all that depreciation into one year, earnings will improve to the extent you no longer are taking depreciation charges in the future."

Companies should turn to Financial Accounting Standard No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, for guidance about taking an impairment charge on a long-lived asset or a group of such assets, says Jeff Ellis, managing director at Huron Consulting Group.

FAS 144 requires a company to take an impairment loss when it projects that the undiscounted cash flow to be generated from a given asset is less than the amount at which the asset is carried on the books. At that point, the company must measure the current fair value of the asset and take an impairment charge for the difference between the fair value and the carrying amount.

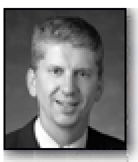
"Long-lived assets" is a broad category on the balance sheet that includes any long-term, prepaid items that a company uses to do business. It includes fixed assets like property, plants, and equipment, as well as other prepaid items like deposits or prepaid services where a company is expecting to get some value out of a contract for an extended time, Ellis explains.

Impairments can also help cash flow in other ways, according to valuation firm Duff & Phelps. Companies should see the impairment event as an opportunity to look for reductions in personal property taxes, to review whether fixed assets are properly classified and should be depreciated differently, and generally to shore up asset records to assure that disposed or abandoned assets aren't still lingering on the books.

In a recent Webcast on impairments, Ross Prindle, managing director for Duff & Phelps, said companies tend to dwell on the negative, but should instead look for the benefits of impairments.

"OK, we've got an impairment, but now what can we do to alleviate [the effects]?" he said. "Try to focus on some things to maximize cash flow for the company going forward."

Taking Initiative



Bob Herman, also a managing director for Duff & Phelps, cited property taxes as one area where companies can exercise the initiative. Property taxes are typically assessed based on a mass-appraisal approach, he said, which wouldn't necessarily capture any individual property owner's reduced property value. So it's up to the property owner to speak up.

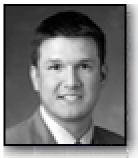
"If an impairment has occurred, it's overwhelmingly likely you have a property tax benefit to pursue," he said. "When you report to the [Securities and Exchange Commission], the SEC does not send an e-mail to taxing authorities informing them of [the impairment] so they can reappraise your property."

Herman recommends filing an appeal with the relevant taxing authorities, providing plenty of documentation to support the new asserted value. Of course, tax authorities may challenge it, perhaps arguing the value should be set at the historical cost. "It's incumbent upon you, the taxpayer, to make sure your opinion of value is achieved," he said.

In some jurisdictions, goodwill may be wrapped into property values. In that case, companies need to establish and support a change in the value of goodwill as well, Herman said. Impairment of goodwill and other intangible assets is a separate accounting exercise governed by FAS 142, *Goodwill and Other Intangible Assets.*

Mark Simzyk, a director with Duff & Phelps, said now is a good time for companies to reconcile their fixed-asset records if they've taken or expect to take impairments, to help support claims for reduced property taxes. By cleaning up fixed-asset records, companies may find unrecorded asset retirements or partial retirements, idled equipment, or transfers that will reduce the tax valuation basis. The reconciliation may also reveal intangible costs embedded in the fixed-asset ledger, which will reduce the tax basis, and the company may be able to document assets that qualify for exemptions.

As an example, Simzyk said some state laws treat tools, molds, and dies separate from the manufacturing machinery they support, yet many companies lump those values in with the machinery values. Segregating those values in the fixed-asset records will assure exempt items are not taxed, he said.



Matt Jaimes, also a director at Duff & Phelps, said companies would be wise to do a cost-segregation study on their fixed assets, to determine whether assets are properly depreciated. Items added to a building, for example, might have been lumped into the building's 30-year depreciation schedule when in fact they could be written down over a much shorter timeframe.

"The end result of doing this is a fairly dramatic increase in deprecation, which brings down your taxable income, and therefore your income tax bill," he said.

Of course, the decision to take the impairment isn't easy, nor is the cash flow calculation associated with the determination, Hanson says. "It's a tough drill to look into the crystal ball right now and see what the future is going to hold and how long it's going to hold on," he says.

Those issues naturally lead to tension in the audit process as well, as auditors must agree with management's assertions about values and cash flow projections. "There's always tension when you're predicting the future and not just looking into past accounting records," Hanson says. "Your view of the future might be different than my view of the future."

COST SEGREGATION

The following excerpt from the IRS Cost Segregation Audit Techniques Guide provides some background information:

In order to calculate depreciation for Federal income tax purposes, taxpayers must use the correct method and proper recovery period for each asset or property owned. Property, whether acquired or constructed, often consists of numerous asset types with different recovery periods. Thus, property must be separated into individual components or asset groups having the same recovery periods and placed-in-service dates in order to properly compute depreciation.

When the actual cost of each individual component is available, this is a rather simple procedure. However, when only lump-sum costs are available, cost estimating techniques may be required to segregate or allocate costs to individual components of property (e.g., land, land improvements, buildings, equipment, furniture and fixtures, etc.). This type of analysis is generally called a cost segregation study, cost segregation analysis, or cost allocation study.

In recent years, increasing numbers of taxpayers have submitted either original tax returns or claims for refund with depreciation deductions based on cost segregation studies. The underlying incentive for preparing these studies for federal income tax purposes is the significant tax benefits derived from utilizing shorter recovery periods and accelerated depreciation methods for computing depreciation deductions. The issues for Service examiners are the rationale used to segregate property into its various components, and the methods used to allocate the total project costs among these components.

The most common situation is the allocation or reallocation of building costs to tangible personal property. A building, termed section (§) 1250 property, is generally 39-year property eligible for straight-line depreciation. Equipment, furniture and fixtures, termed section (§) 1245 property, are tangible personal property. Tangible personal property has a short recovery period (e.g., 5 or 7 years) and is also eligible for accelerated depreciation (e.g., double declining balance). Thus, a faster depreciation write-off (and tax benefit) can be obtained by allocating property costs to § 1245 property, or by reallocating § 1250 property costs to § 1245 property.

A simple example illustrates the tax benefits of a cost segregation study. In general, a turnkey construction project includes elements of tangible personal property (e.g., phone system, computer system, process piping, storage tanks). It is relatively easy to identify these items as § 1245 property and allocate a portion of the total project costs to them. However, a cost segregation study may also report certain building occupancy items, such as carpeting, wall coverings, partitions, millwork, lighting fixtures, suspended ceilings, doors, as § 1245 property. These items may or may not constitute qualifying § 1245 property depending on particular facts and circumstances, such as the location of the assets and the specific activities for which the project was designed.

In addition to identifying specific project components that qualify as § 1245 property, cost segregation studies may treat portions of building components as § 1245 property. For example, a study may conclude that 15 percent of a building’s electrical system directly supports § 1245 property, such as specialized kitchen equipment. Based on that conclusion, the study will then treat 15 percent of the electrical system as § 1245 property. The allocation of building components to § 1245 property is often a contentious issue.

Property allocations and reallocations are typically based on criteria established under the Investment Tax Credit (ITC). A plethora of legislative acts, court decisions and Service rulings have produced complex and often conflicting guidance with respect to property qualifying for ITC, resulting in no bright-line tests for distinguishing § 1245 property from § 1250 property. Related issues, such as the capitalization of interest and production costs under IRC § 263A and changes in accounting method, add to the complexity of this issue.

In a recent landmark decision, the Tax Court ruled that, to the extent tangible personal property is included in an acquisition or in overall costs, it should be treated as such for depreciation purposes. The court also decided that the rules for determining whether property qualifies as tangible personal property for purposes of ITC (under pre-1981 tax law) are also applicable to determining depreciation under current law. [See Hospital Corporation of America, 109 T.C. 21 (1997)] The Service acquiesced to the use of ITC rules for distinguishing § 1245 property from § 1250 property.

Based on these developments, the use of cost segregation studies will likely continue to increase. Unfortunately, there are no standards regarding the preparation of these studies. Accordingly, studies vary widely in terms of the methodology, documentation, depth, format, and expertise of the study's preparer. This lack of consistency, coupled with the complexity of the law in this area, often results in an examination that is controversial and burdensome for all parties.

Examiners reviewing cost segregation studies must determine the proper classification and correct costs of property. In some cases (e.g., small projects) examiners may be able to evaluate a study without assistance. However, other studies may require specialists with expertise, industry experience and specialized training (e.g., Engineers, Computer Audit Specialists and/or Technical Advisors). Examiners should perform a risk analysis as early as possible to determine the depth of an exam and the need for assistance.

Source

IRS: Cost Segregation Audit Techniques Guide.
