ASSESSING IMPAIRMENT OF ASSETS IN PRACTICE

Impairment and asset valuation has long been one of the most challenging areas of financial statement preparation. However, it is a key area of focus for both investors and regulators, so directors need to be familiar with the estimates and judgments required. This article sets out the key requirements and highlights some common problem areas.

AASB 136 Impairment of Assets sets out the procedures required to ensure that an entity's non-financial assets are carried at no more than their recoverable amount, and the related disclosures concerning that assessment.

It requires a 4-step process:

- Identify which assets are captured by the standard.
- Determine whether there are any internal or external indicators of impairment.
- If indicators exist, or if the assets are goodwill or other intangibles with indefinite useful lives, which must be tested every year, compare the recoverable amount (RA) to the carrying amount (CA).
- If CA exceeds RA, recognise an impairment loss.

Complications arise where the RA for an individual asset cannot be readily determined, and where RA calculations involve significant judgment.

The flowchart below summarises the key steps of AASB 136.

IMPAIRMENT ASSESSMENT:
Are there any indicators of impairment? Or, is the asset goodwill or an intangible with an indefinite Useful Economic Life (UEL)?

IF NO: END.

IF YES: IMPAIRMENT TEST REQUIRED. Can the Recoverable Amount (RA) of the individual asset be estimated?

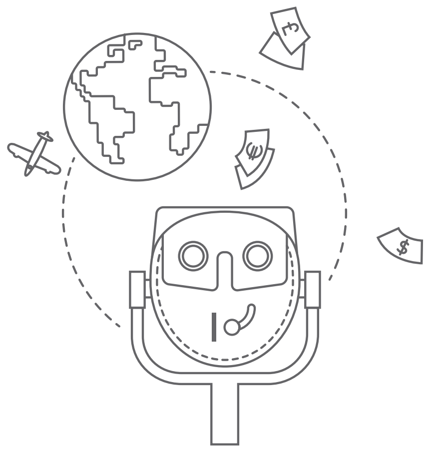
YES: Determine the RA of the asset. CA > RA?	**NO:** Determine the RA of the Cash Generating Unit (CGU) CA > RA?
IF YES: NO FURTHER ACTION REQUIRED: NO IMPAIRMENT.	**IF YES:** NO FURTHER ACTION REQUIRED: NO IMPAIRMENT.
IF NO: Reduce CA to RA: recognise impairment loss.	**IF NO:** Reduce CA to RA: recognise impairment loss.

INDICATORS OF IMPAIRMENT

The first stage is to identify any factors which might indicate the potential for impairment. Common examples include changes in technology, or in market or consumer preferences, or a shift in the economic or legal environment in which the entity is operating. Internal factors can include:

- Physical damage of an asset
- Plans to discontinue or restructure operation
- Any assets or divisions which are idle or operating at reduced capacity or performing below expectations.

If indicators are identified, or if the assets being considered are goodwill or intangible assets with indefinite useful lives, the next step is a consideration of whether the asset's recoverable amount can be identified on its own, or whether the impairment test will have to consider a cash-generating unit instead.



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ASSET OR CASH-GENERATING UNITS?

If it is not possible to estimate the recoverable amount of individual assets, because the asset does not generate cash inflows that are largely independent of those from other assets, the recoverable amount of the cash-generating unit (CGU) to which the asset belongs must be estimated instead.

A CGU is the smallest group of assets that includes the asset in question and generates cash inflows that are largely independent of the inflows from other assets or groups of assets. Typically, a CGU will be an identifiable operation, such as a single retail store, a particular product line, or a geographical area of operations. Identification a CGU can involve judgement based on how the entity's operations are managed and monitored

Having determined what exactly will be reviewed for impairment, the next step is to understand how to determine an asset or CGU's recoverable amount.

CARRYING AND RECOVERABLE AMOUNTS

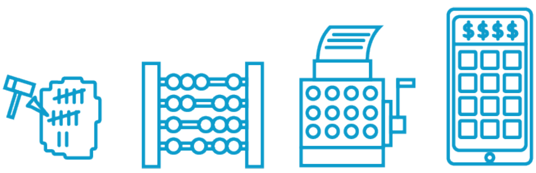
The carrying amount of a CGU includes only the CA of assets that can be directly attributed to the CGU or allocated to it on a reasonable basis, as they will generate future cash inflows in determining its value in use. It does not include the carrying amount of any recognised liability unless the disposal of a CGU would require a buyer to assume the liability.

The recoverable amount of an asset or a CGU is the higher of its fair value less costs of disposal (FVLCS) and its value in use (ViU),

Value in Use is the present value of future cashflows expected to be derived from continued use of an asset or a CGU, based on the future estimated cash flows expected from the asset's continued use in its current form, and applying an appropriate discount rate.

Fair value less costs of disposal is the price that would be received if the asset were sold in an orderly transaction in its current condition, less any sale costs. Where there are no comparable market transactions to determine the FVLCS, it may be estimated by use of a Discounted Cash Flow (DCF).

This differs from a ViU calculation as a DCF model assumes a sale of the asset, rather than continued use from the entity. Thus, it reflects all future events that would affect expected cashflows for a typical market participant that holds the asset, rather than the entity alone. It therefore incorporates market information, the effects of any restructuring, increases in capacity, and synergistic savings within any purchasing entity. Any discount rate is based on what a potential buyer would consider, which may differ from the adjusted market risk-free rate of interest used in a ViU calculation.



DEALING WITH AN IMPAIRMENT LOSS

If the recoverable amount exceeds the asset's carrying value, the asset is not impaired, and no further action is required. If the carrying value exceeds the asset's recoverable amount, the difference should be recognised as an impairment loss against the asset or CGU. For a CGU, the impairment is allocated first against any goodwill, then against other assets in the cash generating unit, on a pro-rata basis determined based on their carrying amount. Where an asset had previously been revalued upwards through reserves, the impairment is first recognised against the uplift in value in reserves, to the extent a reserve exists, with the excess being taken to the profit or loss.

Reversing previously recognised impairment losses

For all assets other than goodwill, there may be instances where external or internal indicators that suggest that a previously recorded impairment loss may no longer exist or may have decreased.

In such instances, the asset's remaining useful life, depreciation or amortisation method, or residual value, would need to be reviewed and adjusted; and a re-evaluation of the recoverable amount of the asset may also be undertaken. If this identifies that the previously-recognised impairment is no longer appropriate, the impairment may be reversed, back up to the amount that would have been recognised if no impairment loss had been previously recognised.

WHAT SHOULD I FOCUS ON?

Impairment assessments and asset carrying values remains the most common area of ASIC focus for its reviews of financial reporting. Where financial statements are audited, failing to carry out impairment assessments promptly can delay financial statement completion, and result in increased costs. We propose 5 steps to avoid these outcomes:

1. Start the process early

The impairment process involves identifying any impairment indicators and estimating recoverable amounts, which involves making reasonable assumptions, and benchmarking them against the market and other publicly available data. To ensure sufficient time for review by the Board and the auditors, this process can be started before the year-end date.

2. Ensure goodwill has been allocated to the appropriate CGUs

Goodwill does not generate cash flows independently from other assets but contributes to the cash flows of existing CGUs. It must be allocated to the CGUs which are expected to benefit from synergies of the business combination, on a non-arbitrary, reasonable and consistent basis, based on how goodwill is internally monitored.

The RA of each CGU to which goodwill has been allocated must be calculated as part of the impairment testing.

3. Ensure the cashflows and discount factors included in models are reasonable and supportable

Cashflow forecasts used in impairment testing should be based on the latest budgets and forecasts, available at the date of the impairment test. They will usually contain assumptions about future sales growth, profit margins, production levels, overhead costs and any other factors affecting the financial performance of the asset or CGU.

Cashflows in a ViU model must reflect expectations for assets in their current condition, and exclude any costs of restructuring, reorganisations, or capital investment, unless the entity is committed to the restructuring and the related provisions have been made.

The discount rate applied should reflect the risks inherent in the CGU. Factors to consider include:

- Corporate lending rates
- Cost of capital
- Risk premiums
- Country and currency risk
- The risk inherent in the specific CGU
- The optimal level of gearing of the company – affect discount rates.

It is advisable to document the basis of all these assumptions, and to evidence the consideration and approval of the key judgments by the Board.

4. Consider whether the results of the impairment test appear reasonable.

Once an initial impairment calculation has been done, ensure the resulting figures are compared against external market data, the market capitalisation of the entity, and past experience of what the entity can reasonably be expected to achieve.

For example, assumptions about the economic climate which were made at the time of approving budgets may not be valid at the time of the impairment assessment, or cashflow growth assumptions may not be in line with consumer confidence indicators, or with the recent performance of the CGU.

A reported net asset value significantly greater than the market capitalisation is usually an indicator of impairment. While it does not mean that an impairment loss must automatically follow, it does suggest that the market is more pessimistic about one or more key valuation assumptions than the directors, so it should prompt close consideration of any forecasts.

5. Ensure you meet the disclosure requirements

Both AASB 136 and AASB 101 Presentation of Financial Statements have extensive disclosure requirements around impairment of assets, fair values, and the use of estimates. The objective of the disclosures is to enable users to form a view on the assumptions made and the recoverability of assets or CGUs, so getting these right is an important part of discharging responsibilities around ensuring fair presentation of financial statements.

> Therefore, it's essential to ensure disclosure of key assumptions, including whether they reflect the entity's experience, and of any reasonably possible changes in assumptions.

Recent inspection activity by ASIC has focussed on missing or inadequate disclosures around the sensitivity of key assumptions in impairment assessments.

For further information, please contact Ralph Martin, National Technical Director, or your local RSM adviser.

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