THE STANDARD STANCE

Practical Tips on Impairment of Assets

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PRACTICAL TIPS ON IMPAIRMENT OF ASSETS

Impairment continues to remain a top area of focus for users of financial statements as well as regulators. Ind AS 36 *Impairment of Assets* sets out the requirements for impairment which covers a range of assets (and groups of assets – termed as 'cash-generating units' or CGUs) and is predominately applicable to property, plant and equipment, intangible assets, right-of-use assets, investments in subsidiaries and goodwill.

Applying Ind AS 36 requires a significant degree of professional judgment and applying it practically remains challenging. Additionally, market regulators across the globe have highlighted that some companies are not including all the required disclosures.

This publication summarises major aspects of Ind AS 36 and provides some practical insights on how companies can navigate the complex accounting requirements in this area.

Indicators/ timing of impairment tests

For certain assets, viz. goodwill, intangibles with an indefinite life and intangible assets not yet available for use, impairment tests are required to be carried out on an annual basis, irrespective of whether any indicators of impairment have been identified.

For others, a formal impairment test is required to be carried out at the reporting date if any impairment indicators are identified. Ind AS 36 requires an entity to consider internal and external indicators when assessing whether there are indicators of impairment.

Practical Tips:

- **Start early -** The timing of impairment tests for goodwill and the two classes of intangible assets does not need to be at the financial year-end. This may permit impairment tests to be at a different time of the year when more internal resources may be available or to align with the entity's budget cycle. However, in such cases, it is important to assess whether there are any indicators of impairment as of the reporting date requiring an additional impairment test.
- **Review past headroom -** The concept of materiality applies to impairment testing for assets that are only subject to impairment testing when indicators arise. For example, if previous calculations show that an asset's recoverable amount is significantly greater than its carrying amount (commonly referred to as 'headroom'), the entity need not re-estimate the asset's recoverable amount if no events have occurred that would eliminate that difference.
- **Formulate a policy for impairment triggers -** A policy for periodic review of external and internal factors (both qualitative and quantitative) could also help timely evaluation of indicators.
- **Pay close attention to market capitalisation -** If market capitalisation (for listed companies) is lower than the net assets, it is an indicator of impairment Although it is possible that the assets are not impaired, a significant difference between these two measures is often a strong indicator that an impairment might exist.

Determining assets/ CGUs and their carrying amount

Ind AS 36 requires that an item assessed for impairment must generate cash inflows that are largely independent of other assets. For many individual assets, this is unlikely to be the case (e.g., a single piece of machinery in a factory would not generate cash inflows that are independent of the cash flows from other assets in the business).

Therefore, in most cases, individual assets (including goodwill) are required by Ind AS 36 to be grouped into CGUs. A CGU is defined as 'the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.'

The composition and nature of CGUs vary from entity to entity and are determined largely by entity-specific factors (although not necessarily its legal structure). Assets are allocated to a CGU if they can be directly attributed or can be allocated to the CGU on a reasonable and consistent basis. The allocation of certain specific items to CGUs is discussed below:

- **Goodwill -** The CGUs to which goodwill is to be allocated must represent the lowest level within the entity at which the goodwill is monitored for internal management purposes, and not be larger than an operating segment.
- **Corporate assets -** These are 'assets other than goodwill that contribute to the future cash flows of both the CGU under review and other CGUs.' In practice, these typically do not themselves generate independent cash inflows, but instead act to 'support' the entity's other CGUs. Common examples would include the corporate office, IT infrastructure, research centres, etc. Corporate assets are normally allocated to CGUs on a reasonable and consistent basis for the purposes of

impairment testing.

- **Liabilities -** Liabilities are only included in the carrying amount of a CGU when the recoverable amount of a CGU cannot be determined without consideration of the liability. For example, where the potential buyer of a CGU would be required to assume the liability (e.g., lease liabilities, restoration provisions, etc.).
- **Working capital balances -** Entities have a choice whether to include or exclude working capital balances from the carrying amounts of a CGU, so long as there is a consistent application to the inclusion or exclusion of cash flows from working capital items in determining the CGU's recoverable amount.

Practical Tips:

- **Management design and monitoring -** Although not definitive, it might be useful to look at how management chooses to organise and monitor its operations to identify CGUs.
- **Cash inflows not outflows -** Identifying CGUs is dependent on establishing groups of assets that generate cash inflows, not net cash flows or cash outflows. Accordingly, if an asset's cash inflows are largely independent but some of the related costs are interdependent with other assets, it might need to be considered separately for determination of recoverable amount.
- **Goodwill gross-up (where applicable) -** In the case of partly-owned subsidiaries, where an entity elects to determine the initial carrying value of goodwill as the excess of purchase consideration over its proportionate share of net assets, it is required to gross up goodwill to reflect 100% of the subsidiary's goodwill. This is logical, as it results in 100% of the net cash inflows being compared to 100% of the net assets in each CGU.
- **Corporate assets allocation -** Corporate assets are normally allocated to CGUs on a reasonable and consistent basis for impairment testing. An entity can rarely justify not being able to allocate corporate assets on a reasonable and consistent basis, and there is a relatively high hurdle to entities making such claims. In such cases, corporate assets should be assessed at an aggregated CGU level for impairment.
- **Consistency with recoverable value determination -** When an entity allocates corporate assets to a CGU, it must ensure that the estimated future cash flows related to those corporate assets are used in determining the CGU's value in use. Similarly, where working capital balances are included in CGU's carrying amounts, the related cash flows should be consistently included/ excluded in determining the CGU's recoverable amount.

Determining the recoverable amount

Ind AS defines an asset's or CGU's recoverable amount as 'the higher of its fair value less costs of disposal and its value in use.'

Fair value is "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." In practice, adequate information may not always be available for an entity to reliably measure the fair value less costs of disposal (FVLCD). In these instances, an entity would be required to determine an asset's (or CGU's) recoverable amount by calculating its value in use (VIU).

VIU is determined through the calculation of an asset's (or CGU's) estimated discounted future cash flows (DCF) with specific requirements and limitations in the standard on what cash flows can and cannot be included for this purpose.

It is common for entities to default to the VIU method because it is often expected to provide a higher value. However, if the VIU model indicates an impairment, the FVLCD must be considered before any impairment is recorded. This approach, therefore, prevents management from making provisions for future operating losses.

Practical Tips:

- **FVLCD or VIU -** Ind AS 36 does not require calculating both the FVLCD and VIU in all cases. It is sufficient to calculate only one of the above amounts so long as that amount exceeds the carrying amount.
- **Reasonableness check -** Entities should include relevant cross-checks to establish the reasonableness of the computed recoverable value by comparison to external market data, where available.

Determining VIU – estimating future cash flows

At a high level, Ind AS 36 requires that the cash flows in a DCF for VIU include (a) only cash inflows from continuing use (b) only cash outflows that are necessary to generate the cash inflows and can be directly attributed, or allocated on a reasonable and consistent basis, including cash outflows to prepare the asset for use, and (c) any net cash flows upon disposal.

Estimated future cash flows should be based on appropriately detailed underlying assumptions, which include changes in working capital and maintenance capital expenditure.

Some of the specific requirements for estimating future cash flows are covered in more detail below:

- **Formally approved management budgets -** The cash flows used in a VIU calculation should be based on budgets formally approved by management. However, some adjustments might be required to comply with the requirements of Ind AS 36; for example, adjustments to make the cash flows represent pre-tax amounts. An overall principle of Ind AS 36 is that cash flows are based on reasonable and supportable assumptions that represent management's best estimate of future cash flows. However, where an entity has a history of not achieving budgets prepared for internal management purposes, additional work may be needed to determine whether the most recent budgets represent realistic forecasts of future cash flows.
- **Forecast period -** The forecast period for entity-specific cash flow projections is not permitted to exceed five years unless a longer period can be justified.

- **Existing assets in current condition -** Future cash flows are projected based on an asset (or CGU) in its current condition at the reporting date. Cash outflows that are necessary to keep an asset (or CGU) in its current condition (e.g., day-to-day serving, maintenance or repair costs) are included in the cash flow projections. Expected future reductions in cash outflows relating to a future restructuring (such as cost savings related to a reduction in staff numbers) to which an entity is not yet committed are not included. However, cost savings from efficiency improvements can be included in cash flow projections. Judgment is required to distinguish between a restructuring program and an efficiency improvement.
- **Compare like with like -** Cash flows used in the recoverable amount should be consistent with the assets being tested in the carrying amount of the CGU. For instance, if the corporate assets have been apportioned across several CGUs on a reasonable and consistent basis, the estimated future cash outflows from the corporate assets must similarly be apportioned. Similarly, the movements in net working capital are included in a CGU's estimated future cash flows if the net working capital balance has been included in the carrying amount of the CGU.
- **Specifically prohibited cash flows -** These include:
  - Future restructuring to which an entity is not yet committed
  - Improving or enhancing the asset's performance
  - Financing activities
  - Income tax receipts or payments
  - Recognised assets and liabilities that generate cash flows largely independent of the cash flows from the asset under review (e.g., financial assets such as receivables) and cash outflows related to obligations that have been recognised as liabilities (payables, pensions, etc.)
  - Non-cash items (such as depreciation and amortisation).
- **Growth rate and terminal value -** Entities are permitted to apply different/ specific growth rates to each year during the forecast period if they are reasonable and supportable. The growth rate used to calculate the terminal value in the terminal period is termed the 'long-term growth rate.' This rate (determined CGU-wise) must not exceed the long-term average growth rate for the products, industries, or country (or countries) in which the entity operates, or for the market in which the asset is used (unless a higher rate can be justified).

Practical Tips:

- **Budget/ forecast for VIU -** Prepare an additional cash flow budget for VIU calculation to exclude any income or expenses arising from future restructurings or planned enhancements to the asset's performance included in recent budgets/ forecasts.
- **Reliability of budgets -** Compare past budgets with actual performance and analyse significant differences before relying on management-approved budgets.
- **External perspective -** Give greater weight to external evidence (e.g., analyst reports) when preparing the cash flow forecast assumptions. Comparable transactions and multiples implied in market transactions can also be useful when evaluating future projections.
- **Forecast period not exceeding five years -** There should be reasonable justification if an entity intends to use a forecast period of greater than five years (such as in the case of a limited life project of a mine with a 7-year forecast period of operations before it is abandoned).
- **Composition, disaggregation and consistency of cash flows -** Cash inflows and outflows that are linked should be consistent. For example, cash outflows relating to the cost of sales would normally be expected to move in line with cash inflows from sales. Cash flows should also be disaggregated at a sufficient level when applying growth trends as not all cash flows will respond in the same way to projected growth - some may increase, decrease, or stay constant (e.g., cost of sales, employee benefits and overheads). Lastly, the cash flows should not include items not allowed to be considered as per Ind AS 36 (as stated in 4(v) above).
- **Long-term growth rate -** Use growth rates that are consistent with the long-term average growth rate relating to the products, industries, or country (or countries) in which the entity operates, or for the market in which the asset is used.
- **Pay close attention to Terminal Value (TV) -** Often TV is the most significant component of the VIU. Hence, this should be reviewed closely, including a review of estimated cash flows in the final year of the forecast period for inclusion of any one-off cash inflows (outflows) not expected to recur in future.
- **Appropriate working capital assumptions -** In practice, many entities simply assume that the change in working capital will be zero (or insignificant). However, this may not be consistent with forecast growth rates.
- **Compare like with like -** For practical reasons, it may be difficult to calculate the VIU without including assets or liabilities which are not part of the CGU (e.g., receivables/ payables). This should be fine so long as the carrying amounts of related assets and liabilities are included in the carrying amount of the related CGU.
- **Consider subsequent events -** Entities should consider the impact of subsequent events, if any, on their cash flow forecasts and related assumptions.

Determining VIU – estimating discount rate

Although estimated future cash flows are specific to the entity, the discount rate is not. Instead, the discount rate reflects the return that market participants would expect from the asset (or CGU) based on its specific risks and the time value of money. However, there must be consistency between the assumptions used in determining the estimated future cash flows and the discount rate. For example, if an aggressive growth rate is included in the cash flows, the discount rate should be adjusted to reflect the risk of not achieving such growth.

The discount rate is usually not observable in the market, meaning that a model or formula needs to be used. One of the more common models that is used in practice is the weighted average cost of capital (WACC). An entity's WACC represents the minimum return that must be earned from its asset base to satisfy both its debt funders and equity shareholders. For the purposes of Ind AS 36, the rate is 'weighted' based on the typical market levels of debt and equity for the entity. This may differ from an entity's balance of debt and equity funding and is designed to ensure that impairment testing is carried out consistently from a market participant, rather than an entity-specific perspective.

While the cost of debt is usually observable (or easily determinable) from the market, this is not usually the case for the cost of equity. This is because the rate of return demanded by equity shareholders varies significantly among different companies, industries and jurisdictions. Therefore, a model usually needs to be used to determine the cost of equity. One of the more common models utilised in practice to determine the cost of equity is the Capital Asset Pricing Model (CAPM). The CAPM involves multiple parameters such as risk-free rate, entity beta and risk premiums.

Practical Tips:

- **CGU-specific discount rate** – It is common for entities to have more than one CGU, with different CGUs exposed to different risks due to exposure to different markets, industries, jurisdictions, products, currencies, interest rates, etc. Ind AS 36 requires a discount rate to be applied to each CGU based on that CGU's exposure to specific risks.
- **Post-tax to pre-tax** - Ind AS 36 requires an entity to use a pre-tax discount rate in the VIU calculation. In circumstances where an entity has used a post-tax rate (typical when using WACC), the pre-tax rate can be determined by using an iterative computation.
- **Specialist advice** - Determining an appropriate asset/CGU-specific discount rate is usually complex. As a starting point, an entity might use its incremental borrowing rate or WACC, adjusted for tax and any atypical capital structure of the entity. Specialist advice may well be required in this regard.

Recognising and allocating impairment loss

If the recoverable amount of an asset (or CGU) is lower than its carrying amount, the asset (or CGU) is impaired. The carrying amount of the asset (or CGU) is then required to be reduced to its recoverable amount. An impairment loss is recognised in profit or loss, except when the related asset is carried at its revalued amount in which case the impairment loss is recognised in other comprehensive income (to the extent that the impairment loss does not exceed the revaluation surplus for that asset).

For individual assets, allocating the impairment loss will be straightforward. Where the impairment relates to a CGU (or to a group of CGUs), any impairment loss is first taken to reduce the carrying amount of goodwill allocated to the CGU, with any remaining impairment allocated to all other assets within the CGU (that are within the scope of Ind AS 36) based on their relative values. This allocation to all other assets must not subsequently result in the carrying amount of these assets being below the higher of (a) FVLCD (if measurable); (b) VIU (if determinable), and (c) Zero.

Practical Tips:

- **Goodwill impairment first** - Any impairment loss identified should first be allocated to goodwill before allocating to other assets within the CGU (except in certain circumstances in which goodwill can only be allocated to a group of CGUs).
- **Floor test** - Allocating impairment loss to other assets should not take their carrying value below their measurable FVLCD (or determinable VIU). This is sometimes referred to as the 'floor test' for allocating impairment losses to various assets within a CGU.

Disclosures

Ind AS 36 requires extensive disclosures for impairment regardless of whether an impairment has been recognised. The disclosures include key assumptions used, management's approach to determining values assigned to each of those assumptions and a sensitivity analysis with reasonably possible changes in the value of key assumptions.

Ind AS 36 requires detailed disclosures on estimates used to measure the recoverable amount of CGUs to which significant goodwill or intangible assets with indefinite lives have been allocated. Entities are also required to disclose the events and circumstances that led to the recognition of an impairment separately for each CGU to which goodwill has been allocated.

Practical Tips:

- **Use disclosure checklist** - Considering extensive disclosures required for impairment, it is advisable to use a disclosure checklist with the specific disclosure requirements of the standard and ensure that all required disclosures have been made in the financial statements.
- **Entity-specific disclosures** - Market regulators have often highlighted the use of boilerplate disclosures for impairment. Entities should ensure that disclosures are specific by identifying all key assumptions, disclosing specifically required items for each CGU, disclosing pre-tax discount rate(s) and disaggregation of disclosed assumptions where multiple CGUs are subject to impairment testing with differing assumptions.
- **Sensitivity analysis with a reasonably possible change** - Common disclosure errors include not presenting a sensitivity analysis including a reasonably possible change thereof and over- or under-estimating the upper and/ or lower boundaries of the analysis (where sensitivity analysis is presented). For example, an analysis that shows the effects of an increase or decrease in the discount rate of 25 basis points would not be appropriate if the experience for interest rates indicated that a reasonably possible change in interest rates was +/- 100 basis points.

Special considerations – climate-related matters

Even though Ind AS 36 does not explicitly reference climate change or its effects on an entity and its cash flows, the effects of climate change should be considered in applying Ind AS 36.

For example, a ban on coal-fired power plants from a specified date by a government may reduce the VIU of the asset. This is an example of the impact of transition risk arising from a change in government regulation.

Alternatively, physical risks should also be considered in applying Ind AS 36. For example, increased wildfires or long-term changes in weather patterns that result from climate change may affect an entity's cash flows, such as the cost of operating assets, increased insurance premiums or the inability of the entity to operate its facilities at all (e.g., agriculture in a region where long-term temperature

increases may make certain crops unviable). An inability to obtain insurance because of more conservative underwriting may also need to be reflected in estimates of future cash flows.

Climate-related matters may give rise to indications that an asset (or a group of assets) is impaired. For example, a decline in demand for products that emit greenhouse gases could indicate a manufacturing plant may be impaired, requiring the asset (or related CGU) to be tested for impairment.

Practical Tips:

- **Consistency with climate disclosures** - Ensure consistency between the disclosures about climate-related matters outside the financial statements (e.g., sustainability reports or management commentaries or published statements) and how climate risk is incorporated in the financial statements.

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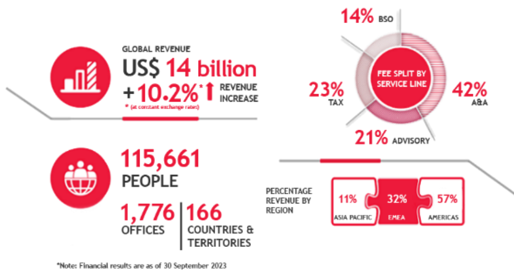

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