

# Audit Committee series

*Audit committee guide to  
impairment  
Key concepts for directors  
June 2014*

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**Audit committee guide to impairment –  
Key concepts for directors June 2014**

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# Foreword

The impairment of assets is a vital aspect of financial reporting yet the concept is not always easily understood. Recent studies into how entities test and apply impairment, as well as regulatory focus in this area, have highlighted the importance of guidance on the topic.

To help directors in fulfilling their obligations in relation to impairment, the Institute of Chartered Accountants Australia has released this guide with an overview of the key concepts. It covers what impairment means and why it is important, and raises questions directors should ask in relation to the methodology used, projected cash flows and disclosures.

This is the eighth guide in the Institute's audit committee series. I trust that it will provide useful information for directors for year-end reporting in understanding some of the more detailed requirements of asset impairment testing.



**Mel Ashton FCA**  
President  
Institute of Chartered Accountants Australia

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*'If impairment is done incorrectly,  
it can have a material impact on  
an entity's financial statements.'*

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# 1. Introduction

Impairment of assets is an important issue. It applies to almost all assets held by an entity (including goodwill) and needs to be considered at each reporting period. If done incorrectly, it can have a material impact on an entity's financial statements.

The purpose of this guide is to provide directors with a high level overview of the concept of asset impairment. It will assist you to understand:

- What impairment means and why it is important
- How impairment is measured
- When impairment needs to be assessed
- The consequences of impairment
- What you should do to ensure impairment issues are being treated appropriately.

This guide is not intended to provide a comprehensive analysis of the intricacies of impairment; rather it aims to provide an overview of key concepts. As a result, a simplified explanation of some of the more detailed requirements is provided.

# 2. What is impairment and why is it important?

If an asset is stated in an entity's accounts at a higher amount than can be recovered through use or sale, the asset is described as 'impaired'.

If an asset is not carried at its correct value, there may be a material misstatement of the financial statements resulting in misleading information being disclosed.

The Australian Securities and Investments Commission is currently focusing on the impairment of assets, with impairment and asset values making up the highest number of enquiries

from its latest review of financial reports. The need for this scrutiny has been reinforced by a number of recent studies that have highlighted how poorly impairment testing is understood, applied and disclosed by corporate Australia.

Impairment testing applies to any entity preparing general purpose financial statements. It applies to each asset, including intangible assets such as goodwill, with a few exceptions. The main exceptions being inventory, deferred tax, and investments stated at fair value.

### 3. How is impairment measured?

#### COMPARISON TO CARRYING AMOUNT

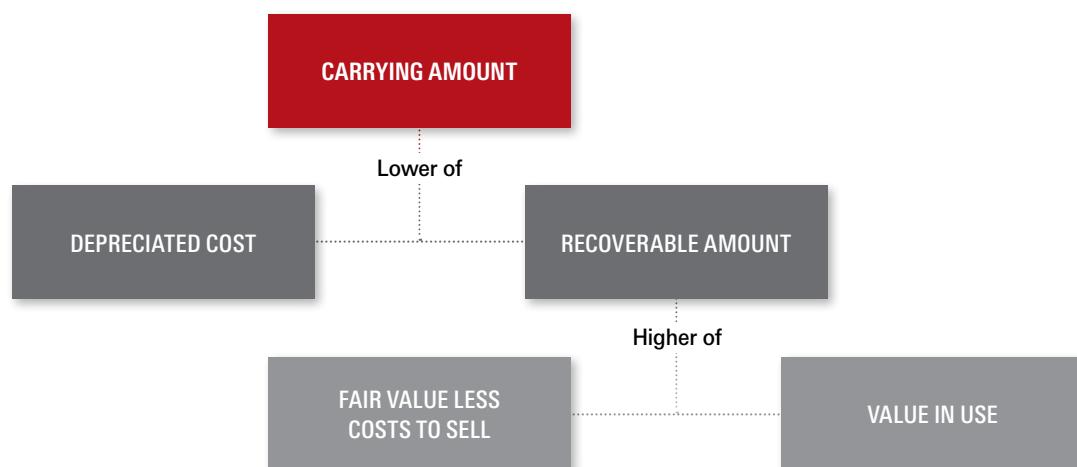
The carrying amount of an asset must be the lower of depreciated cost and its recoverable amount i.e. the amount that can be recovered through the use or sale of the asset. If the recoverable amount is below the carrying amount the asset is impaired.

#### RECOVERABLE AMOUNT

Recoverable amount is the higher of fair value less costs to sell and value in use. Fair value is based around what a hypothetical market participant would be willing to pay for the asset in an arm's length transaction. Value in use is a measure of what the asset is worth to the entity that holds it. There is a significant amount of detailed guidance on the concepts of fair value and value in use provided in AASB 13 and AASB 136. Appendix A of this guide highlights some of the important issues to be considered and differences between the two measures of value.

#### SUMMARY

These concepts are summarised in the following diagram:



## 4. When is impairment testing required?

The requirement for impairment testing falls into two broad categories:

### INDICATION OF IMPAIRMENT

Each entity must assess whether there has been an indication of impairment at the end of each reporting period. If there is an indication then formal impairment testing must be undertaken. A list of potential factors indicating impairment is provided in Appendix B.

### ANNUAL TESTING

Each entity must test indefinite life intangibles (including goodwill) for impairment at least once every year. This test must be undertaken regardless of whether there are any indications of impairment.

Where impairment testing is required this may be done in a three-step process:

**1** Assess one of:

- Fair value less costs to sell; or
- Value in use.

If the amount assessed is higher than the carrying amount no further testing is required.

**2** If step 1 indicates a potential impairment, then another measure of value should be determined. If this amount is higher than carrying amount then nothing further is required.

**3** If step 2 also results in a value below the carrying amount, then impairment needs to be recognised based on the difference between the carrying amount and the higher of fair value less costs to sell and value in use.

## 5. What happens if an asset is impaired?

Where the recoverable amount of an asset or cash generating unit (CGU) is less than its carrying amount, it is impaired. The carrying amount of the asset or CGU must be written down to its recoverable amount. The impairment loss is the difference between the carrying amount and the recoverable amount and is recorded as an expense in the statement of financial performance (the Profit and Loss).

The exception to this is in relation to revalued assets recorded in an equity reserve, in which case the impairment is treated as a decrease in revaluation, which is not an expense in the statement of financial performance.

# 6. Goodwill and CGUs

One area that is frequently misunderstood is the application of impairment testing to goodwill and CGUs. If an asset does not generate cash inflows which are largely independent of those from other assets (e.g. goodwill) the recoverable amount assessment should be undertaken on the CGU to which the asset belongs as a whole.

## WHAT IMPAIRMENT TESTING IS REQUIRED?

Impairment testing of CGUs with goodwill must be undertaken annually.

## WHAT HAPPENS IF THE CGU IS IMPAIRED?

If a CGU is impaired, the impairment is initially applied against goodwill. If the impairment is greater than the goodwill allocated to the CGU any remaining impairment is applied pro-rata to other assets held by the CGU. It is also important to consider whether the identifiable intangible assets are also impaired.

## WHAT DISCOUNT RATE SHOULD BE USED?

The discount rate applied should reflect the riskiness of the CGU being tested and should be based on the rates of return market participants would use to evaluate the CGU.

The discount rate applied should NOT:

- Be based on the discount rate applicable to the whole entity that owns the CGU (unless the risk profiles are the same)
- Reflect the specific financing applied by the owner of the CGU in acquiring the CGU (for example the discount rate applied to a CGU acquired with debt finance is not the cost of debt).

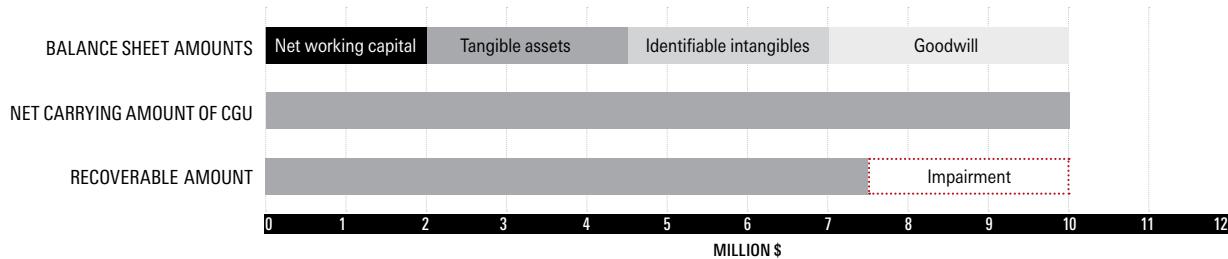
## WHAT DOES THE DISCOUNTED CASH FLOW VALUE MEAN?

The result of the discounted cash flow analysis reflects the value of the whole CGU, not simply the goodwill. To understand whether there is impairment it is necessary to compare this number with the net carrying amount of all the assets and liabilities that belong to the CGU.

### EXAMPLE:

The fair value less costs to sell for a CGU is assessed at \$6.0 million based on a capitalisation of earnings approach. The value in use, determined using a discounted cash flow approach, is determined at \$7.5 million. The recoverable amount is therefore \$7.5 million.

The CGU has allocated goodwill of \$3.0 million and identifiable intangibles of \$2.5 million. Is there impairment? To answer this question two more pieces of information are needed – the level of tangible assets held by the CGU (\$2.5 million) and the level of working capital (\$2.0 million).



As shown in the figure above, the net carrying amount of assets employed in the CGU is \$10 million, \$2.5 million greater than the recoverable amount, so there is impairment of \$2.5 million.

# 7. Disclosure

AASB 136 contains detailed disclosure requirements.

This guide highlights only the key items.

## IMPAIRMENT TESTING

For each CGU with a significant amount of goodwill or indefinite life intangibles the following must be disclosed:

- The carrying amount of goodwill and intangible assets with indefinite lives
- Whether recoverable amount has been determined by reference to fair value or value in use
- Where impairment testing is based on discounted cash flow analysis:
  - A description of key assumptions
  - The period over which cash flows are projected
  - Growth rates used
  - The discount rates applied
- Details regarding any key assumptions for which a reasonably possible change could lead to impairment.

## IMPAIRMENT LOSSES

Disclosures for each material impairment loss include:

- The events and circumstances that led to the loss
- The amount of the loss
- Whether the recoverable amount is based on fair value or value in use
- The discount rate used if recoverable amount is based on value in use.

# 8. What should you do about impairment?

As a director you need to:

- Ensure impairment testing is performed
- Seek adequate explanations for assumptions used
- Understand growth rates assumed
- Understand discount rates used

- Ask your auditors what their key concerns are in regard to impairment testing and whether they have received adequate support from management for key assumptions.

As a guide we recommend you understand the answer to the following ten key questions.

## TEN CRITICAL QUESTIONS TO ASK REGARDING IMPAIRMENT

QUESTIONS	SUGGESTED RESPONSES
<b>IN RELATION TO METHODOLOGY USED:</b>	
1. Has impairment testing been performed?	If there is any goodwill, or indefinite lived intangible assets (e.g. brands), the answer must be yes. If not, a review of indications of impairment should be performed (see <b>Appendix B</b> ).
2. What methodology was used?	If recoverable amount is based on value in use, a discounted cash flow analysis must be used. For fair value, capitalisation of earnings (multiples) may be appropriate if there are a sufficient number of publicly traded comparable entities.
<b>IN RELATION TO PROJECTED CASH FLOWS:</b>	
3. Is there sufficient allowance for capital expenditure to justify the growth assumptions?	A frequent error in discounted cash flow analysis is to assume significant growth without making an allowance for capital expenditure. One way to check this is to compute projected return on equity/return on assets and ensure it remains within industry norms.
4. What terminal growth assumptions have been made?	Generally this should not be more than 2% to 3%. In a small number of industries, growth may be linked closer to GDP than inflation in which case a slightly higher figure may be justified.
5. Do the cash flows include interest expense?	Unless the entity is a financial services business the answer should be no.
<b>IN RELATION TO THE DISCOUNT RATE:</b>	
6. Was the discount rate used for each CGU based on the riskiness of that CGU?	The answer should be yes. Companies will generally have different discount rates for different CGUs.
7. How has the cost of equity been estimated?	Based on market rates of return for businesses with similar risks, typically using the capital asset pricing model.
8. What assumptions have been made about the cost and level of debt?	Debt levels and interest rates should reflect those that the asset or CGU could achieve on a standalone basis and not based on the support it can be provided by a parent entity.
9. Are the discount rates and cash flows used consistent in their treatment of inflation, tax and debt?	Typically discounts rates and cash flows should be post-tax and nominal (including inflation). The impact of debt should be allowed for in the discount rate and not the cash flows.
<b>IN RELATION TO DISCLOSURE:</b>	
10. Have all relevant disclosures been made in the financial statements, including key assumptions?	There are numerous disclosures regarding impairment which should be made.

# Appendices

## APPENDIX A: FAIR VALUE AND VALUE IN USE

The inputs to a valuation will depend on whether fair value or value in use is being assessed. Value in use reflects the value of an asset to the entity that holds it. Inputs are therefore based on management's view of the cash flow from ongoing use by that entity. Fair value reflects an external arm's length transaction. Inputs are therefore based on a market participant's view of the asset.

	FAIR VALUE	VALUE IN USE
<b>Definition</b>	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.	The present value of the future cash flows expected to be derived from an asset or CGU.
<b>Perspective</b>	Hypothetical market participants.	Current owner.
<b>Methodology</b>	The methodology that a market participant would use. Which, depending on the nature of the asset may include: <ul style="list-style-type: none"> <li>• Market approach (e.g. multiples, matrix pricing)</li> <li>• Cost approach (e.g. current replacement cost)</li> <li>• Income approach (e.g. discounted cash flow, option based techniques).</li> </ul>	Discounted cash flow.
<b>Period of analysis</b>	If discounted cash flow analysis is used, the period of the analysis will be the period that a market participant would use. This will vary substantially depending on the nature of the business.	Cash flows should be projected for a maximum of five years (plus a terminal value) unless an ability to forecast accurately over a longer period can be demonstrated.
<b>Assumptions</b>	If discounted cash flow is used, the cash flows should be based on a market participant's views, not management's view. This should include: <ul style="list-style-type: none"> <li>• The impact of any restructuring that would be considered by a market participant;</li> <li>• The impact of enhancements that a market participant would be expected to consider</li> <li>• Removing any owner-specific synergies.</li> </ul>	Cash flow forecasts should be based on reasonable assumptions. But should exclude cash flows from: <ul style="list-style-type: none"> <li>• A future restructuring</li> <li>• Enhancing the asset's performance.</li> </ul> Cash flow forecasts should include corporate overheads where they can be allocated on a reasonable basis.
<b>Debt</b>	May either be included explicitly in the cash flows, or allowed for in the discount rate.	Exclude from cash flows (i.e. ignore interest expense and debt repayments). Allowed for in the discount rate.
<b>Tax treatment</b>	Typically cash flows and discount rates are post tax.	AASB 136 requires the analysis to be prepared on a pre-tax basis. However, it is common practice to use post-tax cashflows with a post-tax discount rate. The pre-tax discount rate is then determined and disclosed.
<b>Discount rate</b>	The discount rate is based on the assumptions market participants would use when pricing the asset or liability. This would include assumptions about risk.	The discount rate reflects the owner's current market assessment of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted.
<b>Terminal value</b>	Based on market participant assumptions.	Cash flows shall be extrapolated beyond the period of management forecasts using steady or declining growth rates which generally should not exceed the long-term growth rates of the industry or country in which the CGU operates.

## APPENDIX B: INDICATIONS OF IMPAIRMENT

- Unfavourable technological changes have occurred or are expected
- Unfavourable changes in the economic environment
- Unfavourable legal changes have occurred or are expected
- Market rates of return have increased significantly
- An entity's net assets exceed its market capitalisation
- Obsolescence
- Physical damage
- An asset becoming idle
- Plans to discontinue or restructure an activity
- Financial results are not meeting previous expectations.

## APPENDIX C: DISCOUNT RATE CONSIDERATIONS

Regardless of whether fair value or value in use is used to assess the recoverable amount, if a discounted cash flow is used, one of the most critical assumptions is the discount rate.

The discount rate used is not the discount rate appropriate for the parent company but is the discount rate appropriate for the asset or CGU being valued. Thus a company could reasonably be expected to have separate discount rates for each CGU or business where the areas of activity and the associated risks vary.

Information regarding the calculation of a discount rate is beyond the scope of this guide. However, a discount rate is typically calculated using the following two formulae for the cost of equity ( $K_e$ ) and the weighted average cost of capital (WACC):

$$K_e = R_f + \beta (R_m - R_f) + \alpha \quad WACC = K_e(E/V) + K_d(D/V)(1-t)$$

The key components of the above formulae are:

$K_e$	Cost of equity (return required by an equity provider)
$R_f$	Risk free rate
$R_m$	Market rate for a diversified share portfolio
$\beta$	Beta – which is a market measure of relative price volatility
$(R_m - R_f)$	Market risk premium (MRP)
$\alpha$	Alpha – company specific risk
$WACC$	Weighted average cost of capital
$E/V$	Market efficient proportion of equity (E) in the capital structure (V)
$D/V$	Market efficient proportion of debt (D) in the capital structure (V)
$K_d$	Cost of debt
$t$	The corporate tax rate

AASB 136 states that when determining the discount rate for a value in use calculation, it should reflect current market assessment of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted.

Similarly AASB 13 requires that the discount rate is based on the assumptions market participants would use when pricing the asset or liability. This would include assumptions about risk.

It is generally accepted the same discount rate should be used regardless of whether a fair value or value in use calculation is being undertaken.

# Glossary

<b>AASB 13</b>	Australian Accounting Standard AASB 13 Fair Value Measurement
<b>AASB 136</b>	Australian Accounting Standard AASB 136 Impairment of Assets
<b>ASIC</b>	Australian Securities and Investments Commission
<b>Carrying Amount</b>	The amount at which an asset is recognised in an entity's accounts
<b>Cash Generating Unit</b>	The smallest identifiable group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets
<b>CGU</b>	Cash generating unit
<b>Fair Value</b>	The amount obtainable from the sale of an asset or cash generating unit in an arm's length transaction between knowledgeable, willing parties
<b>GFC</b>	Global Financial Crisis
<b>Recoverable Amount</b>	The higher of fair value less costs to sell and value in use
<b>Value in Use</b>	Present value of future cash flows expected to be derived from an asset or cash generating unit



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