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A&A Accounting Technical
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# Clarity in financial reporting

## Focusing on impairment issues for June 2017

CONTENT



## Talking points

- Directors have responsibility to ensure impairment is identified and reported on a timely basis
- The impairment requirements of the standards can be both prescriptive and subject to significant judgement in some areas. Management should take care to ensure that all requirements are understood and appropriately applied
- Impairment tests should be conducted by comparing 'apples with apples', i.e. ensuring that the carrying amount being tested is consistent with the underlying assumptions made in recoverable amount models
- Getting an appropriate impairment testing outcome requires underlying assumptions and forecasts to be reasonable, supportable and consistent with the requirements of standards
- Transparency in disclosure is also important, ensuring that users of financial reports are provided with relevant disclosure about impairment, including sensitivities
- Impairment calculations require proper planning to ensure the appropriate methodology and all requirements of the standards are met. We would encourage entities to perform the testing prior to year-end to enable sufficient time to fully consider all the relevant requirements, document rationale and approaches, and inform the market (where relevant)
- This edition of *Clarity in financial reporting* outlines some relevant observations on impairment testing of non-financial assets that can be used to identify issues for the 30 June 2017 financial reporting season.

For more information please see the following websites:

www.iasplus.com

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## Why focus on impairment now?

Directors are at risk where impairments are not identified and reported on a timely basis.

The impairment testing process required under Australian Accounting Standards (specifically AASB 136 *Impairment of Assets*) is both complex and prescriptive. However, there is much subjectivity and judgement involved in applying the requirements, and many issues lack specific guidance.

In addition, the Australian Securities and Investments Commission (ASIC) continues to concentrate on impairment related issues as part of its financial reporting surveillance program. It is common for ASIC to ask companies for copies of their impairment documentation and models as part of their surveillance activities. Directors and management are responsible for ensuring impairments are identified and reported on a timely basis. In addition, companies may receive negative press coverage if restatements occur.

In some cases, impairment testing may be highlighted in the new 'Key Audit Matters' section of the independent audit report, which will bring additional attention to the impairment testing process and disclosures provided in the financial report.

The purpose of this publication is not to provide an in-depth technical analysis of the relevant Accounting Standards, but instead to provide a summary of learnings and commonly misunderstood areas of the impairment testing process.

Focusing on these areas will allow companies to stay ahead of the curve.

**What are some of the commonly misunderstood impairment issues?**

| Topic | What should I be thinking about? |
|---|---|
| **Identifying cash-generating units (CGUs)**<br><br>Identifying an entity's cash-generating units (CGUs) correctly is fundamental to the impairment testing process. Goodwill must be allocated in a manner consistent with how it is monitored by the entity and cannot be greater than an operating segment. | • The definition of a CGU requires the identification of an asset's CGU on the basis of independent cash inflows generated by the asset, not independent net cash flows (i.e. cash inflows and outflows). Therefore, outflows such as shared infrastructure and marketing expenditures are not considered when identifying a cash-generating unit<br>• The requirement to not exceed an operating segment when allocating goodwill applies to all entities regardless of whether they are required to disclose segment information<br>• The identification of CGUs should generally be consistent with the entity's internal reporting structure. |
| **Choosing assumptions**<br><br>The output of a discounted cash flow model is dependent upon the assumptions made, and incorrect assumptions can result in the wrong conclusions and impairment outcomes. | • Assumptions made must be reasonable and supportable, weighted towards external evidence and based on approved budgets and forecasts. Where a value in use (ViU) model is used to determine recoverable amount, forecasts used should not exceed 5 years (and exclude the impact of future restructurings or expansion). Subsequent projections should assume a steady or declining growth rate which does not exceed the long term growth rate averages relevant to the entity's products, industries, countries in which it operates or for the market in which the asset being tested is used<br>• Discount rates used in discounted cash flow (DCF) models should reflect the specific risks associated with the asset or CGU being tested and consider optimal levels of financing. The entity's company-wide weighted average cost of capital (WACC) may reflect diversification and less than optimal leveraging indicating that it may not best reflect the specific risks associated with the CGU being tested for impairment<br>• Where a fair value less costs of disposal model is used, the assumptions made should be consistent with those a market participant would use, maximise the use of observable inputs and be cross checked against other information<br>• Budgets and forecasts used in models should be reasonable and supportable, and reasons for differences between past performance and budgets considered and documented where relevant. |

| Topic | What should I be thinking about? |
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| **Comparing 'apples with apples'**<br><br>A core principle when testing for impairment is that the items included in the carrying amount of a cash-generating unit are consistent with the cash flows in DCF models used to determine the recoverable amount of that CGU. | • The carrying amount being tested usually includes more than just any property, plant and equipment, intangible assets, allocated goodwill and working capital<br>• Depending on how models are constructed, it may be necessary to include other assets and liabilities, including debt factoring, provisions and cash flows hedges. Where included, different discount rates used to measure the item and discount the associated cash flows included in the model need to be carefully considered<br>• DCF models are often conducted on a post-tax basis in practice, which raises the issue of whether deferred taxes should be included in the carrying amount of the CGU being tested. Deferred tax balances arising from temporary differences would generally only be included in the carrying amount if the entity's specific tax circumstances are reflected in the model (i.e. the model reflects the tax cash flows arising from the reversal of the temporary differences rather than reflecting tax outflows at 30% of forecasted EBITDA, subject to the impacts of discounting). Furthermore, the benefit of existing tax losses should not be included when determining tax cash flows included in models. |
| **Working capital**<br><br>Nearly all models used for impairment testing implicitly or explicitly include an allowance for working capital. For example, most terminal values used in ViU models would assume a 'normal' level of working capital to enable the CGU to continue operating in perpetuity. | • The carrying amount of cash-generating units (CGUs) should ordinarily include the carrying amount of working capital<br>• Adjustments should be made in DCF models to both (1) 'normalise' working capital over the projection period of the model (or through adjustment to the carrying amount) and (2) include cash flows to adjust working capital to be consistent with growth assumptions (i.e. working capital often increases in line with sales growth). |
| **Corporate assets/costs**<br><br>Impairment testing models need to consider both the allocation of corporate assets such as headquarter buildings and corporate costs. | • All recoverable amount models should include an allocation of corporate assets in the carrying amount being tested, or otherwise an 'aggregate' impairment test is required for groups of CGUs which benefit from the corporate assets<br>• Entities must document how the allocation process is to be conducted, ensuring that it is a 'reasonable and consistent' basis<br>• In addition, impairment model cash flows should include an allocation of the corporate costs incurred by the entity, either on a direct attribution basis or allocated on a reasonable and consistent basis (e.g. based on usage patterns, the level of activity or some other basis). |
| **Performing cross checks**<br><br>ASIC and other regulators are increasingly focusing on how much corroborating evidence has been considered as part of the impairment testing process. | All entities should document their consideration of public information that is relevant to impairment tests. Examples include:<br>• For listed entities, ensuring the entity's market capitalisation is compared with the entity's net assets and that differences are understood and explained<br>• Using all relevant broker reports related to the entity to 'sense check' recoverable amount models, and documenting reasons for differences<br>• Comparing recoverable amount with other information on the basis of implied multiples, recent transactions and other benchmarking information (including documenting why these other sources are considered relevant). |

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| | **Reconciliations**<br><br>A key part of the overall testing process should include high-level checks and balances that provide management with additional comfort that all relevant balances and costs within the financial statements have been considered in the impairment testing. | These checks could include:<br>• Reconciling the carrying amount of assets and liabilities in the balance sheet with the aggregate carrying amounts used in impairment models – this ensures all assets are considered for impairment<br>• Reconciling the consolidated EBITDA of the entity to the cash flows used in the various impairment models – to ensure that all relevant cash flows have been considered<br>• Reconciling the corporate costs of the entity to recoverable amount models<br>• Reconciling the aggregate recoverable amounts determined with the entity's market capitalisation, particularly where the entity has a limited number of CGUs.<br>These reconciliations should be performed even if particular assets or cash generating units are not specifically tested for impairment, as it ensures that no assets or cash flows are missed for any CGU that is tested for impairment. |
| | **Exploration and evaluation**<br><br>There are different impairment triggers for impairment involving exploration and evaluation assets, notably a lack of a market capitalisation trigger for exploration and evaluation assets. | • It is critical in getting the correct impairment outcome that a correct determination is made of when assets are no longer accounted for as exploration and evaluation assets, based on all known factors. Therefore we recommend that entities have a documented accounting policy assessing these factors<br>• Factors that might individually or collectively indicate a project is no longer in the exploration and evaluation phase include: making the final investment decision, granting of mining or production permits, draw down of development financing, commencement of the building of mine infrastructure such as rail networks or machinery access roads, or entering into binding supply arrangements with creditors and customers. |
| | **Transparent disclosures**<br><br>Regulators and others continue to focus on the quality and transparency of impairment related disclosures because these disclosures are important in understanding critical judgements made in assessing impairment. | • Companies need to ensure impairment related disclosures tell a realistic and understandable story about the company's assets and impairment testing, i.e. are consistent with management's understanding of the company's assets and economic prospects and also consistent with other information such as subsequent event disclosures, market announcements and internal information such as the assessment of the recoverability of deferred tax assets<br>• A strong focus is required on disclosure around why impairments have occurred (where applicable) and sensitivities in assumptions that may cause an impairment. |

## Conclusion

Experience has shown that to ensure an appropriate assessment of the recoverability of assets is performed, it is important to clearly document the judgements and assumptions applied as well as consideration of the Accounting Standard.

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