ACCOUNTING AND CORPORATE REGULATORY AUTHORITY

AUDIT PRACTICE BULLETIN NO 2 OF 2010

IMPAIRMENT OF NON-FINANCIAL ASSETS

30 NOVEMBER 2010

An excerpt of this article was first published in the Fourth Public Report of the Practice Monitoring Programme in July 2010.

1. The widespread economic slowdown experienced in the recent years has affected many businesses and has led to lower than expected cash flows from non-financial assets. This increases the likelihood that the carrying amounts of assets are greater than the present values of expected cash flows from the assets, giving rise to a possible need to record impairment charges for the affected assets.

2. For assets that are subject to annual impairment testing, such as goodwill and intangible assets with indefinite useful lives, management may need to reconsider assumptions applied in prior periods' impairment testing in light of the prevailing economic environment. For non-financial assets, other than goodwill and intangible assets, management may no longer be able to provide evidence that there has been no indication of impairment and may need to perform detailed impairment testing.

3. Where the recoverable amount of an asset is less than its carrying amount, FRS 36 *Impairment of Assets* requires an impairment loss to be immediately recognised in the income statement to reduce the carrying amount of the asset to its recoverable amount. The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use. It is common for the recoverable amount of an asset or the cash-generating unit to which the asset belongs to be determined based on value in use calculation as determining the fair value less costs to sell of an asset may not always be possible especially in an inactive market.

4. For value in use calculation, the overall key driver that determines the amount of any impairment charge is the cash flow projections. In formulating the cash flow projections, management should re-assess all key inputs to the cash flow such as the forecast sales volume, assumptions about selling prices, wage and raw materials based on the prevailing economic climate. Consideration should also be given to the macro-economic impact such as the loss of purchasing power, volatility of raw material prices and other risks such as currency, price, finance and country risks during an economic downturn.

5. ACRA's main findings in the area of impairment testing of non-financial assets performed by the public accountants are as follows:
   - Failure to identify the appropriate cash-generating unit to which an asset belongs;
   - Inadequate impairment assessment carried out on pre-operating or start-up subsidiaries;
   - Failure to consider impairment of underlying assets prior to using the net tangible assets value of subsidiaries to assess for indications of impairment of investments in subsidiaries;
   - Failure to justify the basis of using profit (instead of cash flow) projections for value in use calculation;
   - Incorrect comparison of amounts when assessing impairment;
   - Insufficient testing of or challenges to the cash flow projections prepared by management;
   - Reasonableness of discount rates used not adequately assessed; and
   - No assessment of reversal of impairment loss previously recognised

Failure to identify the appropriate cash-generating unit to which an asset belongs

6. An asset's cash-generating unit (CGU) is the smallest group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets[1]. The identification of an asset's CGU involves judgement and consideration of various factors including how management monitors the entity's operations (such as by product lines, businesses, individual locations, districts or regional areas) or how management makes decision about continuing or disposing of the entity's assets and operations[2].

7. ACRA noted that, in most of the reviewed engagements, the public accountant treated the legal entity as the CGU and carried out impairment assessments of the entity's assets such as property, plant and equipment at the entity level. This may not be appropriate in situations where an entity is engaged in more than one activity, each capable of generating largely independent cash inflows. For example, in the case of an entity which is involved in both manufacturing and investment holding activities, the public accountant should consider whether each activity should be regarded as a separate CGU for impairment assessment and testing purposes. Treating the entity as the CGU may lead to an inappropriate conclusion that there are no impairment issues on the assets used, say, for the manufacturing activities despite losses incurred on those activities on the logic that the entity is profitable on an overall basis due to income generated from its investing activities.

[1] FRS 36.68
[2] FRS 36.69

8. The public accountant should critically assess the appropriateness of the CGU identified by management and document such assessments in the engagement files. The public accountant should also challenge the asset groupings determined by management to ensure that the groupings are not set at too high a level as a smaller number of asset groups increases the chance that stronger assets i.e. assets generating higher cash flows can offset losses in weaker assets. In assessing the appropriateness of the asset groupings, the public accountant should consider the consistency of approach used by management in the determination of operating segments for the purpose of segment reporting under FRS108 *Operating Segments*.

Inadequate impairment assessment carried out on pre-operating or start-up subsidiaries

9. A newly set-up subsidiary in its pre-operating or start-up phase is likely to have a net tangible assets value which falls short of the cost of investment made due to pre-operating costs incurred or initial losses incurred before operations are ramped up to an optimal level. ACRA has observed that the work done to assess impairment of the investment in such subsidiaries tends to be cursory and limited to inquiries of management without obtaining further corroborative audit evidence to support the conclusion that no impairment is required.

10. The public accountant should obtain and review management plans for the subsidiary to ascertain if operations are in line with management plans and determine whether the cost of the investment has become impaired. A wider implication arising from the impairment assessment is the impairment consideration of the net assets of the loss-making subsidiary which in turn would potentially impact the group financial statements.

Failure to consider impairment of underlying assets prior to using the net tangible assets value of subsidiaries to assess for indications of impairment of investments in subsidiaries

11. ACRA noted the prevalent use of the net tangible asset value of a subsidiary to assess whether there is any indication that an investment in a subsidiary has been impaired before the public accountant carries out a more detailed impairment testing based on projected cash flows prepared by management.

12. FRS 36.12 requires the consideration of both external and internal sources of information when assessing whether there is any indication that an asset may be impaired.

13. Therefore, the public accountant should document the consideration given to the other indicators of impairment as listed in FRS 36.12 or provide justification for using net tangible assets value as the ***only*** basis for not performing a detailed review of impairment.

14. Further, prior to using the net tangible assets value to assess impairment indicators, public accountants should consider whether an impairment write-down is required of the underlying assets (such as consideration of impairment loss on the subsidiary's property, plant and equipment where the subsidiary itself is loss-making or on recorded receivables from loss-making or insolvent fellow subsidiaries) as this would in turn affect the net tangible assets value and may impact the conclusion.

Failure to justify the basis of using profit (instead of cash flow) projections for value in use calculation

15. FRS 36.31 requires that value in use estimates be based on future cash flows derived from the continuing use of the asset and from its ultimate disposal. ACRA has observed the use of profit-before-tax as a proxy for the projected cash flows in the initial impairment assessment prior to carrying out a full impairment assessment based on projected cash flows. This approach may be appropriate where there are no significant non-cash items included in profit-before-tax or where the operating cash flows generated do not closely approximate profit-before-tax. Public accountants should evaluate and document the appropriateness of management's use of such proxies in support of value in use calculations.

16. When using profit projections to determine value in use as discussed above, public accountants should take care not to omit cash outflows from expected future capital expenditures necessary to support the projected revenue growth in the calculation.

Incorrect comparison of amounts when assessing impairment

17. In assessing impairment of goodwill arising from the acquisition of a subsidiary, which has been determined to be the CGU, where the recoverable amount is determined based on the value in use calculation, ACRA noted instances where the value in use amount was compared only to the goodwill balance instead of the summation of the goodwill balance and the net assets value of the subsidiary as at the date of impairment assessment. This is not in accordance with FRS 36.90, which states that "*A CGU to which goodwill has been allocated shall be tested for impairment annually, and whenever there is an indication that the unit may be impaired, by comparing the carrying amount of the unit, including the goodwill, with the recoverable amounts of the unit.*"

18. FRS36, Appendix C, paragraph C4[3], further provides that for the purpose of impairment testing a non-wholly-owned CGU with goodwill, the carrying amount of that unit is adjusted by grossing up the carrying amount of the goodwill allocated to the unit to include the goodwill attributable to the non-controlling interest before being compared with its recoverable amount. However, ACRA has observed instances where the carrying amount of goodwill was not appropriately grossed up prior to its comparison against the recoverable amount of the CGU.

19. For impairment assessment of investment in a non-wholly-owned subsidiary, it should be noted that the discounted cash flows from the subsidiary (to be compared against the cost of investment in the subsidiary) should be based on the entity's effective equity interest in the subsidiary.

Insufficient testing of or challenges to the cash flow projections prepared by management

20. Examples of sub-standard audit work observed in the area of test of cash flow projections by the public accountants include:
    - No assessment of the impact on the value in use calculation arising from the omission of cash flows from capital expenditures and the future disposal of the operations.
    - Failure to discount the projected cash flows to present value before comparing them to the carrying amount of the asset that is the subject of the impairment review to establish whether an impairment loss has occurred.
    - Reliance on the business plan without sufficient challenge to the assumptions (such as the revenue growth rates, profitability rates, terminal growth rates) used by management in preparing the forecasts.
    - No assessment of the appropriateness of the growth rate applied for expenses vis-a-vis the growth rate used for revenue.
    - No assessment of the reasonableness of the discount rate applied to the cash flow projections in order to derive present value.

21. Public accountants should assess the assumptions used in the business plan to ascertain whether they are reasonable and supportable and consistent with market evidence. Public accountants should appropriately challenge the key assumptions behind the cash flow projections. The review of cash flow projections should be performed by senior members of the audit team and should not be delegated to junior members who may lack the necessary experience to perform a rigorous review and the clout to challenge management's assumptions. In reviewing the cash flow projections, the public accountant should ask of management, *inter alia*, the following:

[3] FRS 36, Appendix C, paragraph C4 is effective in respect of audits of financial statements for periods beginning on or after 1 July 2009. The equivalent paragraph under FRS 36 prior to this date was FRS 36.92.

- How the changes in market conditions, changes in sales volume, pricing and costs have been incorporated into cash flow projections;
- Whether the projected margins, which are sometimes based on historical trends, is reasonable in a tough economic environment i.e. the public accountant should question the relevance of using historical gross margins in the projections given the change in economic conditions;
- How much room the entity has with its debt covenants; and
- Whether appropriate risk adjustments have been made to the cash flow projection for risks such as counterparty risk, credit risk, liquidity risk and market risk.

22. It is critical that cash flow projections are appropriately stress tested. Sensitivity analysis should be performed for changes in sales volume, pricing and costs as examples. "What if" scenarios such as 10-15% decrease or more in sales are not far-fetched in times of economic uncertainties.

23. Public accountants may also consider the use of experts to cross-check the reasonableness of management's value in use calculation such as based on comparison of the implied earnings multiples resulting from the value in use calculation to market multiples for the entity, comparable quoted companies and, if any, comparable transactions. When using the work of an expert, public accountants should evaluate the professional competence and objectivity of the expert as required under the revised SSA 620 *Using the Work of an Auditor's Expert* and document such evaluation in the files.

24. The cash flows used for impairment testing should be based on the most recent business plan that reflects the expected impact of the economic downturn. Public accountants should check that the cash flow projections given by management for impairment purposes are consistent with the budgets that are presented to senior management and the Board.

Reasonableness of discount rates used not adequately assessed

25. In deriving the recoverable amount, the cash flows from the future use of the assets must be discounted to present value. Given the increase in market risk under depressed economic conditions, a corresponding increase in discount rates would be expected. Factors that affect discount rates also include government interest rates, corporate lending rates and cost of capital. The discount rates used should be carefully considered for reasonableness.

26. ACRA noted instances where the rates used by management were based on the prevailing cost of borrowings which had not been adjusted to reflect the way that the market would assess the specific risks associated with the entities' estimated cash flows, timing and risk profile equivalent to those that the entity expects to derive from the asset. These risks may include country risk, currency risk and price risk. The public accountant should document the work performed to assess the appropriateness of the discount rates used by management with reference to the requirements in FRS 36.55-57.

27. ACRA also noted an instance whereby management applied an arbitrary and unsupportable discount to the value in use to account for subjectivity and inherent uncertainty in the assumptions used in the discounted cash flows. Such a basis is inconsistent with the requirements of FRS 36. The public accountant should instead address the subjectivity element in the cash flow projections specifically and ensure that the relevant stress tests on the estimates such as growth rate, gross profit margin and discount rate using the sensitivity analysis are performed.

No assessment of reversal of impairment loss previously recognised

28. FRS 36.114 provides that an impairment loss recognised in prior periods for an asset other than goodwill is to be reversed if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. Changes in estimates include a change in the basis for recoverable amount, a change in the amount or timing of estimated future cash flows or in the discount rate or a change in estimate of the components of fair value less costs to sell.

29. As economic conditions improve, businesses are likely to generate higher cash flows which may necessitate the reversal of impairment losses previously recognised during the economic downturn. ACRA would expect public accountants to apply the same level of rigour in assessing whether impairment losses previously recognised should be reversed as was applied when the losses were originally recognised. Public accountants should also take note of requirements under FRS 36.117 and FRS 36.122 in ascertaining the amount of impairment loss to be reversed for an individual asset and for a cash generating unit respectively.
