

Questions and answers on impairment of non-financial assets in the current crisis

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The last 12 months have been marked by increased volatility in global markets. The credit crisis has become a widespread if not global slowdown and ripples are being felt in territories and markets across the world as economic growth slows. The economic downturn in many countries may worsen as the financial crisis continues.

The widespread slowdown means that assets and businesses in many industries will generate lower cash flows than expected. This increases the likelihood that asset carrying amounts are greater than the expected cash flows from the assets. Impairment charges may well be required. IAS 36, 'Impairment of assets' is one of the more complicated standards and this can make getting the accounting and disclosures right more of a challenge. The volatility of currency and commodity markets and unpredictable interest rates add a further layer of complexity to impairment testing this year.

PwC has compiled a practically focused set of questions and answers on impairment testing of non-financial assets in current economic conditions. These Q&A provide practical guidance on impairment indicators to look out for, timing of impairment tests, suggestions on how to do an impairment test in volatile markets and what disclosures are critical to the market and regulators in the current environment.

1. Is the economic crisis an impairment indicator?

Yes. An economic crisis as severe as the current one is generally considered a triggering event for impairment testing. Although an economic downturn isn't, prima facie, an impairment indicator the individual economic phenomena that make up the crisis may well be indicators for many companies. Almost all businesses will be impacted by one or more of the economic factors; even businesses that are expecting to weather the downturn or take advantage of the crisis. In addition to the required annual impairment testing of goodwill and indefinite lived intangible assets, the market expectation is that many preparers across most, if not all, industries will perform impairment tests prior to this coming year end.

The following impairment indicators might be particularly relevant in the current economic climate:

- FY08 actual figures are significantly lower than the original 2008 budget.
- Cash flow is significantly lower than earlier forecasts.
- Material changes in mid-term and/or long-term growth rates as compared to the previous estimates.
- Significant or prolonged decrease in the entity's stock price.
- Market capitalisation less than book value of net assets.
- Announced change in business model, restructuring, discontinued operations, etc.
- Increase in the entity's cost of capital.
- Change of market interest rates or other market rates of return.
- Fluctuations in the foreign exchange rates or commodity prices that impact the entity's cash flows.
- Deferral of investment projects.

This list is not comprehensive. Other indicators may present themselves. The indicators above and in the standard are examples only.

2. Should an impairment test be re-performed at year end if already performed earlier in the year?

Goodwill and other indefinite useful life intangible assets should be tested at a minimum once every year, irrespective of whether there is any indication of impairment. The annual impairment test does not necessarily have to be performed at year end, but must be performed at the same time each year. For example, it can be performed mid-year. However, those assets should be tested again for impairment at year end if any indicators of impairment exist in the period between the date of the annual impairment test and the year end.

Indicators of impairment may appear within a short period of time in the current economic environment. Indicators of potential impairment loss therefore need to be monitored more closely in current conditions. Management should be prepared to update impairment tests at year end.

3. What is the most significant variable or input for a year end impairment test?

Every input to the VIU or FVLCTS calculation should be assessed in the current economic conditions and the inputs should present a coherent picture. The overall key driver that determines the amount of any impairment charge will be the cash flow forecasts

The cash flow forecast will include forecast sales volumes, assumptions about selling prices, currency, wage and raw material costs. Particular attention might also be given to the impacts of the macro-economic indicators (for example, loss of purchasing power, volatility of energy and raw material prices) when assessing revenue growth and profit margins. Other risks to be considered include currency risks, price risks, finance risks and country risks.

Discount rates are also relevant and a change in the discount rate will have an immediate impact on the recoverable amount.

4. Should the business plan prepared by management be revised to incorporate the impact of the economic crisis?

Yes. Cash flows used for impairment testing should be based on a business plan that reflects the expected and most current impacts of the economic downturn. Management will be updating forecasts and plans in response to current conditions. This most recent plan is expected to be updated and approved by management and the governing board. Reliance on a previously approved forecast may not be prudent in the current market conditions. The inputs to the projections should be benchmarked against available market data.

Management should reassess the business plan assumptions based on their best estimates, even if the level of uncertainty is likely to be higher this year compared to prior years.

5. How can management ensure that the assumptions underlying the business plans are relevant?

The assumptions used in the business plan need to be reasonable and supportable. In the current context of uncertainty:

- Management assumptions should be consistent with market evidence, such as independent macroeconomic forecasts, industry commentators or analysts, brokers' analysis and other third-party experts. Greater weight should be given to any external evidence that is available.

- Any differences between the business plan's underlying assumptions and market evidence should be analysed and understood. Management may find it helpful to explain these differences in disclosures or other material accompanying the financial statements.
- Management should analyse any differences between fair value less costs to sell and value in use and ensure they are supportable.

6. Is it relevant in the current economy to use a discounted cash flow approach to determine fair value less costs to sell?

Yes. A discounted cash flow approach remains relevant and appropriate in current volatile market conditions in determining fair value less costs to sell. A DCF remains relevant to the extent that it reflects both the short-term and long-term expectations of cash flows that would be realisable by a market participant (without implying that the asset is held for sale). It might be more difficult to implement this approach in the current environment, as one of the major difficulties is to estimate reliably the appropriate cash flow projections from the view of a hypothetical buyer.

However, this approach might result in a higher recoverable amount than a value in use calculation, as it allows inclusion of the positive impacts of restructuring programmes not yet announced and any major capacity investments. Such restructuring programmes should be assessed from a market participant perspective and only included where it is believed that a market participant would undertake a restructuring.

In some circumstances, value in use might result in a higher recoverable amount than fair value less costs to sell. This arises when, for example, the entity benefits from internal specific synergies not available to any other market participant. The impact of the synergies can be taken into account in the value in use calculation, resulting in a higher recoverable amount than a fair value less costs to sell calculation.

When fair value less costs to sell is used, the overall result from the discounted cash flows should be benchmarked to market data (for example, comparable companies and implied transaction multiples).

7. How can impairment tests be more reliably performed in periods of uncertainty?

Two approaches to constructing the cash flow model can be considered:

- The 'traditional' approach, which consists of using a 'single set of estimated cash flows and a single discount rate' taking into account the 'appropriate discount rate (IAS 36.A4). Uncertainties are reflected through the risk premium included in the discount rate.
- The 'expected cash flow' approach, which consists of using 'all expectations about possible cash flows instead of the most likely cash flow' (IAS 36.A7). Uncertainties are reflected through probability-weighted cash flows.

Theoretically, the above two approaches should provide the same result. However, this relies on a degree of precision in the estimates under the traditional approach that is difficult to achieve

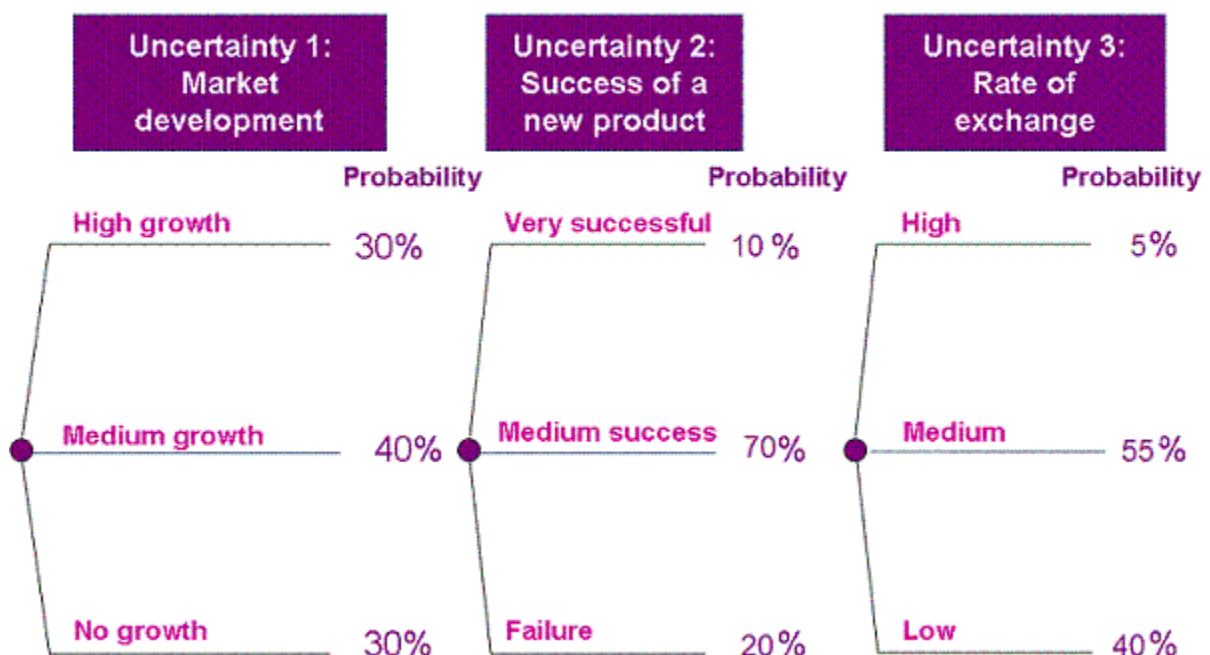
A basic assumption in calculating discount rates is that the expected cash flows fully reflect the uncertainties related to the current economic downturn. Management should consider probability-weighting different scenarios to estimate the expected cash flows.

The expected cash flow approach has, among others, the following advantages in an environment of higher uncertainty:

- The sensitivity of the recoverable amount to uncertainties is explicit in the measurement compared to the 'traditional' approach where it is factored into the discount rate.
- It enables management to assess the uncertain assumptions that may have the most significant impacts on the recoverable amount.
- It calculates a range of expected cash flows instead of only considering the most likely case.
- It may be more aligned with the way management prepares forecasts.
- It lessens the impact of the judgemental exercise inherent in choosing a single specific risk premium, which may be difficult to quantify and document.

Example

Impairment test : modeling of uncertainty



Management has identified three crucial uncertainties that might affect the business plan: market developments, the success of a new product, and the exchange rate. For each uncertainty, three cash flow projections have been identified with the probability that they will occur. The recoverable amount will equal the expected value resulting from the combination of the twenty seven ($3 \times 3 \times 3$) possible scenarios.

8. What are the consequences of the financial crisis on the discount rate?

The discount rate should reflect the time value of money for the periods until the end of the asset/cash generating unit (CGU)'s useful life, market risks, country risks, risks specific to the assets/CGUs, and other factors that market participants would reflect in pricing the expected future cash flows. As a starting point in calculating such a rate, management might use the weighted average cost of capital.

Despite the financial crisis, the established methods for calculating the cost of capital should continue to be used. However, a reassessment of each input into the calculation and assessment of the overall result is needed and might result in a different discount rate than the one used in prior-year financial statements.

In a discounted cash flow approach, cash flows are discounted over a long period. The key components of the discount rate should also be viewed over the long term. The equity market risk premium has historically reflected a long-term view and would not be expected to change in the current market.

However, other components of the weighted average cost of capital, such as spreads in credit markets, have increased significantly and are highly volatile. The spread level to be retained in the weighted average cost of capital should be assessed on a case-by-case basis. Short-term fluctuation peaks are less relevant.

The discount rate does not simply result from the application of a formula. It requires the exercise of judgement based on the overall valuation exercise. In particular, if the cash flows are not believed to incorporate a sufficient level of risks and therefore cannot be considered as the expected cash flows, the discount rate might need to be adjusted upwards. However, management should first attempt to adjust the cash flows prior to making any adjustments to the discount rate, as it is generally difficult to estimate and support the amount by which the discount rate should be adjusted. To the extent that uncertainties are not reflected in cash flows (for example, through probability-weighting) they may have to be reflected as an additional specific risk premium in the discount rate.

9. Can management still use recent asset transactions (if any) or trading multiples taken from stock prices as appropriate benchmarks?

Management should be cautious in relying on recent observable market transactions to benchmark discounted cash flow valuations. Due to high volatility in share prices, management might need to observe trading multiples over longer periods, rather than making a single point estimate. However, market prices should still be used as a consistency check, as there is a clear need to take into account all market evidence. Observable market transactions cannot be assumed to be distressed sales without careful consideration of the circumstances and all relevant evidence.

10. Should the impairment test be updated for any material changes in assumptions after year-end date but before the issuance date of the financial statements?

The impairment test should be updated after year end only if material changes in assumptions provide additional evidence relating to conditions that existed at the balance sheet date. This requires an analysis of facts and circumstances in order to distinguish between adjusting and non adjusting information. This is a difficult judgement but a continuation of a previously observed trend does not usually warrant further adjustment as the trend should have been incorporated into the most recent impairment calculation. Currency and foreign exchange movements subsequent to year end would also seldom be a reason to update year end impairment calculations. However, information available subsequent to year end that indicates that conditions were much worse than thought might indicate that management should update impairment calculations.

For example, an entity might make the following assessments:

- Statistical figures released in February 2009 on consumer spending in Q4, 2008 indicating a 20% contraction in the relevant industry, whereas the expected figure was 10%, may be an adjusting event.
- Incremental cash flows forecasts arising from a decision made in January 2009 to launch a new product is a non adjusting event.
- Further fall in oil price in January 2009 due to the cooling in the economy is a non adjusting event.

Significant information or changes subsequent to year end should be disclosed in the financial statements if the impact is material.

11. Should goodwill from recent transactions be tested for impairment if a triggering event exists and the allocation of goodwill to cash-generating units has not been completed by the end of the reporting period?

Yes. An impairment test should be performed at each reporting date whenever an indication for impairment exists. This requirement applies to goodwill as well as to other assets (IAS 36.9). If there is a clear indication of impairment, it would not be appropriate to leave goodwill untested because the initial allocation relating to a business combination in the current reporting period has not been completed.

The level at which the goodwill is tested depends on facts and circumstances, including the level of information available at year end.

Any adjustment of the impairment charge arising from the finalisation of the purchase price allocation and allocation of goodwill would be accounted for retrospectively.

12. Which disclosures will be of particular interest to financial analysts and regulators this year?

Financial analysts and regulators are focusing on getting detailed and current information in this period of market turbulence. IAS 36, 'Impairment of Assets', IAS 1, 'Presentation of financial statements', and IAS 10, 'Events after the balance sheet date' all prescribe relevant disclosures. Also, there are often specific requirements of regulators that should be incorporated in the financial statements to the extent they provide meaningful information to the readers of the financial statements and reflect management's views and judgements when assessing recoverable amounts.

The critical disclosures for the upcoming year end reporting cycle will be related to sensitivity analyses (ie, key assumptions that have a significant risk of causing a material adjustment to the carrying amount of assets including goodwill). These key assumptions should not be restricted to discount rates or growth rates but might also include expected profit margins and other highly sensitive assumptions that may have a significant impact on future cash flows. Other disclosures where there is heightened risk of impairment include:

- A description of the asset/CGU being tested.
- The amount by which the recoverable amount exceeds the carrying value.
- The values assigned to the key assumptions used in the sensitivity analysis.
- The amount by which the key assumptions would have to change where the change would result in the recoverable amount equalling the carrying amount. For example, an entity might disclose that a 1% increase in the pre-tax discount rate would reduce its recoverable amount to equal its carrying amount.

- The aggregate carrying amount of goodwill allocated to the CGU(s) and the aggregate carrying amount of intangible assets with indefinite useful lives allocated to the CGU(s).

Presented below are a couple of actual disclosure excerpts (names, amounts and countries have been changed) related to sensitivity analysis and key assumption disclosure.

Excerpt 1

Key assumptions and sensitivities

The fair value less costs to sell and value in use tests are sensitive to a number of assumptions which are discussed in turn below:

Discount rate – Future cash flows for the Territory A CGU are discounted using a discount rate of 12.5% (2007: 12.5%). A movement in discount rate of 50 basis points to 12%/13% would result in a decrease in the impairment loss of \$45 million/increase of \$36 million in the Territory A CGU. Territory B CGU's future cash flows are discounted using a discount rate of 13.5% (2007: 13.5%).

Long term growth rate – Cash flows beyond a five year period are extrapolated using a growth rate of 2.5% (2007: 2.5%). The growth rate does not exceed the long term growth rate for the business in which the CGUs operate. A movement in the long term growth rate of 0.5% to 2.0%/3.0% would result in an increase in the impairment loss of \$21 million/decrease of \$27 million in the Territory A CGU.

Exchange rate – The Territory A CGU recoverable amount test converts forecasted international cash flows at the exchange rate expected to be in place at the time of the forecast transaction. Most international cash flows for the Territory A CGU are forecast from Europe (Euro). The recoverable amount test includes a forecast Euro exchange rate of \$1 = Euro 1.x for 2009 graduating down over the five year forecast period. Had the Euro exchange rate expectations been one cent lower/higher over the forecast period, the Territory A impairment would be, on average, \$19 million lower/higher. Territory B CGU does not have significant international cash flows.

Excerpt 2

Impairment tests for goodwill

The recoverable amounts for the Operation A CGU have been determined based on value in use calculations. These calculations use cash flow projections based on financial budgets approved by management covering a period of one year. Cash inflows for years 2 – 5 have been increased at an average rate of 3.2% per annum. This rate is in accordance with the observed annual growth rate for Operation A's industry for the 5 years ended December 2007 combined with management's expectations of declining growth. Cash outflows for years 2-5 have been increased at a rate of 2.8% as a blended estimate of expected wages and GDP growth. A growth rate of zero has been applied from year 5 into perpetuity. The growth rates applied do not exceed the long-term average growth rate for the business in which the CGU operates. The discount rate used is 15.5% which reflects the Group's pre-tax nominal weighted average cost of capital. Management's assessment of Operation A's value in use materially exceeds its carrying value, therefore any significant changes to assumptions used in management's assessment will not result in impairment.

13. How should a listed associate be tested for impairment when its stock price has significantly declined?

An investor applies IAS 39 to identify potential impairment indicators in an associate accounted for under IAS 28. If any indicators exist, the investment is subject to an impairment test in accordance with IAS 36, comparing the carrying amount to the recoverable amount of the asset. These requirements are not only applied to the investor's equity interest in the associate, but also to other long-term interests that in substance form part of the investor's net investment in the associate, all of which are financial interests in the associate.

The carrying amount is not automatically written down to the current share price. The price decline is an indicator and also establishes the 'fair value less costs to sell' of the associate. However, IAS 36 requires that the recoverable amount under value in use should also be calculated before recording an impairment loss. If the value in use is higher than the carrying amount of the investment there is no impairment loss to recognise.

Calculating the value in use implies obtaining cash flow forecasts from the associate's management. The value in use should be determined carefully. The value in use is estimated with assumptions of cash flows taking into account the actual economic environment. However, a listed company often operates under restrictions about selective disclosure of information. Management of the associate may be unwilling to provide a cash flow forecast or prohibited from doing so by legislation. The investor may need to create its own estimated cash flows using publicly available data or possibly use analyst forecasts. The future expected dividend streams from the investment in associate could also be used in measuring value in use of the associate. Both cash flow sources should produce the same result.

An associate normally meets the definition of a CGU as it usually generate cash inflows from continuing use that are largely independent of those from other assets of the reporting entity

The investor could also consider the underlying assets of the associate, calculate the investor's share of the value of the assets (which typically is discounted to reflect minority shareholding) and compare it with the carrying amount of the investment in the associate to assess impairment.

Impairments of investments in associates can be reversed in accordance with IAS 36.