

Impairment testing of non-financial assets in the current crisis

What is the issue?

The widespread economic 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.

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

Impairment charges may well be required in accordance with NZ IAS 36 *Impairment of Assets*. In this first edition of *IFRS in brief* in New Zealand, we have compiled a list of practical questions and answers on impairment indicators, timing of impairment tests and how to do an impairment test in volatile markets.

Is the economic crisis an impairment indicator?

Yes, the following are particularly relevant indicators 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 share 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 market rates of return,
- Fluctuations in the foreign exchange rates or commodity prices that impact the entity's cash flows.

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

The annual impairment test does not necessarily have to be performed at year end, but must be performed at the same time each year. However, those assets should be tested again for impairment at year end if any indicators 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.

What is the most significant variable or input for an impairment test?

The overall key driver will be the cash flow forecasts, which will include forecast sales volumes, assumptions about selling prices, wage and raw materials. Particular attention should also be given to the impacts of the macro-economic indicators such as loss of purchasing power, volatility of energy and raw material prices. Other risks to be considered include currency risks, price risks, finance risks and country risks.

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. The most recent plan is expected to be updated and reliance on a previously approved forecast may not be prudent.

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 and consistent with market evidence. Any differences between the assumptions and market evidence should be analysed and understood. Management should analyse any differences between fair value less costs to sell and value in use and ensure they are supportable.

Is it relevant to use a DCF approach to determine fair value less costs to sell?

Yes. A DCF approach remains relevant and appropriate in current volatile market conditions to the extent it reflects both the short-term and long-term expectations of cash flows. When fair value less costs to sell is used, the overall result from the DCF should be benchmarked to market data, for example comparable companies and implied transaction multiples.

What are the consequences of the financial crises on the discount rate?

Despite the financial crises, 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.

Can management still use recent asset transactions as appropriate benchmarks?

Management should be cautious in relying on recent market transactions to benchmark DCF valuations. Due to high volatility in share prices, management need to observe trading multiples over longer periods.

The allocation of goodwill to entities' segments

What is the issue?

Earlier this month the IASB released its proposed 2009 annual improvements, which is a timely and efficient way to make (non-urgent) amendments to IFRS. One of the proposals clarifies how the new segment standard, NZ IFRS 8, impacts on goodwill impairment testing under NZ IAS 36 *Impairment of Assets*.

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

Currently, entities performing the goodwill impairment test cannot allocate goodwill to a cash generating unit (CGU) or a group of CGUs that is larger than a segment. The IASB's proposal aims to make clear that entities must assess their impairment at or below the un-aggregated operating segment level. Therefore, any subsequent aggregation of operating segments for disclosure purposes will not change the entity's assessment of the recoverable amount of goodwill.

When entities adopt NZ IFRS 8 they may need to redefine their operating segments. Some entities may also need to reallocate their goodwill balance to a lower level group of CGUs, which may expose them to goodwill impairment and volatility of earnings. In this edition we identify what entities should do to prepare for the changes.

Who does it impact?

Entities that have goodwill currently allocated to a cash generating unit that is larger than an operating segment. *Entities that qualify for differential reporting must only test goodwill for impairment if indicators are present. If a test is undertaken, it must be allocated to a CGU in accordance with this amendment.*

When does it impact entities?

NZ IFRS 8 is mandatory for all entities that do not qualify for differential reporting and with annual periods beginning 1 January 2009. If endorsed, the proposed changes to NZ IAS 36 will be mandatory for entities with annual periods beginning 1 January 2010.

What is the impact on entities in practice?

NZ IFRS 8 requires entities to identify their operating segments based on the information that is provided internally to the chief-operating decision maker (for example, the CEO, chief operating officer, the senior management team, or the board of directors). For some entities, this requirement will increase their number of operating segments or require them to cut their segments differently (see table below). These entities may need to reallocate the goodwill on their balance sheet and reconsider its recoverable amount.

For example, assume Entity A acquired Entity B and recognised goodwill that related to Entity B's retail and wholesale activities. Under the previous segment reporting standard (NZ IAS 14) these two components or CGUs were identified within the same business segment and the goodwill was tested for impairment at the segment level. Under NZ IFRS 8, if those two business units are regularly reviewed by the entity's chief-operating decision maker they will need to be split into two operating segments. The goodwill in these segments will need to be reallocated to the relevant CGUs and tested for impairment on that basis.

Key impact of the new NZ IFRS 8	Key impact of amendment to NZ IAS 36
For some entities, NZ IFRS 8 will increase their number of operating segments. Moreover, internal business units of vertically integrated operations that were classed as one segment under NZ IAS 14 may now need to be split into several smaller segments based on the level of financial reporting information used by the chief-operating decision maker to allocate resources.	Based on the proposed changes to NZ IAS 36, some entities will need to reallocate the goodwill on their balance sheet to a lower level CGU or group of CGU's for the purposes of impairment testing. This process can be time-consuming and complex for entities. It may also trigger more impairment of goodwill and increase the volatility of earnings where the recoverable amount of the segment assets (including the goodwill) is below carrying amount.

What do impacted entities need to do?

- Become familiar with the new requirements in NZ IFRS 8 and the proposed revisions to NZ IAS 36.
- Consider whether your segments are likely to change under the new standard. Review the goodwill that is currently on your entity's balance sheet and consider whether it needs to be reallocated to a CGU or group of CGUs that is not larger than an operating segment.
- Consider the basis for the reallocation, and remember that the basis must be relevant and reliable (for example, based on the relative fair value of the operating segments).

PwC insight: Don't presume you're not impacted and be aware of the risk of restatement

If the proposed changes to NZ IAS 36 are adopted, some entities may need to change the way they cut their segments and reallocate the goodwill on their balance sheet. These entities will also need to restate comparative information and reallocate goodwill under the new requirements in the prior accounting period.

Entities will need to make additional disclosures to explain the reasons for changing the way their CGUs are identified and assets aggregated. There is no requirement to re-test goodwill for impairment in prior periods.