

Greater risk of impairment in today's market conditions

What is the issue?

Entities are likely to record impairments for the first time under the new standards at June 2008.

The changes to market conditions have meant that impairment test triggers are all around us. The market has changed since entities last prepared financial statements. For some entities, market capitalisation is less than net assets as transactions occurred in a different environment with higher equity prices. There is now greater uncertainty in the economic environment due to higher inflation and the credit squeeze. Higher interest rates mean that the cost of capital is up.

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

Who does it impact?

Entities that identify triggers that indicate their assets may be impaired (ie, due to increased interest rates or a significant decline in the asset's value). These entities must conduct an impairment test.

Why is it important to be aware of now?

Determining impairment should not be a 'last minute' task. All entities should focus now on whether they are likely to have an impairment at 30 June. Early identification of potential asset impairment might allow management to implement a profit improvement strategy, such as a restructure, and avoid an impairment charge.

What do impacted entities need to do?

Determine whether impairment exists by comparing either the fair value or value in use of assets (or a group of assets) with the asset's (or a group of assets') carrying amount. In more buoyant times entities have pointed to prices in the market (fair value). However, with roller coaster market prices we expect to see more entities turn to the value in use method at June 2008 to determine the recoverable amount of assets.

Determining the value in use of an asset involves estimating expected cash inflows and outflows from continuing use of the asset and applying the appropriate discount rate to its future cash flows. If necessary, entities will need to change their forecasts to reflect downturns in economic prospects.

Without such an adjustment entities may get an error in their impairment calculations. Entities' cash flows should be checked for reasonableness when compared to market expectations for the sector/entity. Entities with commodity price exposure and currency exposure will need to freshen up their assumptions.

Don't miss equity accounted investments in associates and joint ventures from impairment testing.

PwC insight: What management should watch out for

- **Be careful that you're really doing a value in use test.** Some tests purport to be value in use, but which are not. For example, the benefit of future reorganisations or future enhancements, such as additions of capital, should not be included in cash inflows. Although these don't qualify for a value in use test, they are permitted when calculating the recoverable amount based on fair value less costs to sell if other market participants would do the same.

- **Make sure that your value in use test makes sense when compared with market data.**

Management should be prepared to explain how and why the valuation implied by its forecasts (based on value in use) are reasonable when compared with market data. Market data is based on the fair value test, which is the price that an entity could obtain for its assets in an arms length transaction. It should also explain benchmark data. For instance, multiples implied by quoted comparable companies, implied multiples from comparable transactions, and share price trends of the entity or similar listed entities.

- **Impairment disclosure requirements are onerous and ASIC will expect full compliance.**

Tick all the boxes to ensure that your entity's disclosure requirements are met. In particular, start collecting data early to ensure that your entity meets the disclosure requirements for cash generating units with goodwill and/or intangible assets. Often these disclosure requirements can be significant.

Proposed changes to customer contributions

What is the issue?

IFRIC has issued a draft interpretation dealing with customer contributions to reduce diversity in practice. It gives guidance on the accounting for the receipt of contributions of property, plant and equipment (or cash) that must be used to provide access to a supply of goods or services to customers. If approved, it would apply prospectively to annual periods beginning three months after the final interpretation is issued.

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

Who does it impact?

If the draft interpretation is approved, it would impact entities that receive:

- property, plant and equipment that is used to provide customers with access to goods/services (for example, a water provider is given access to a customer's water pipe to provide that customer with water); or
- cash to acquire or construct an asset to facilitate the supply of goods/services (for example, when a customer finances the construction of an extension to the electricity network to supply a specific site).

The draft interpretation would also apply when an asset is contributed by a party other than the customer (for example, when a housebuilder constructs an asset that will be used by a utility to supply water to all the houses on the development).

Why is it important to be aware of?

The proposals may mean that some entities that do not currently account for customer contributions will be required to gross up the balance sheet to recognise property, plant and equipment and a liability to provide a future service. These entities would subsequently gross up the income statement with broadly equivalent revenue and depreciation over the period of the service contract.

If the draft interpretation is approved it will have a particular impact on Australian entities that operate in a price-regulated network (for example, power or water utilities). The proposed guidance is fundamentally different to current guidance in AASB Interpretation 1017 *Developer and Customer Contributions for Connection to a Price-Regulated Network*.

What do affected entities need to do if the draft interpretation is approved?

Entities receiving the asset would need to assess whether it qualifies for recognition as an asset (for example, if it is expected to bring future economic benefits it would qualify as an asset).

Assets that qualify for recognition would be recorded initially at fair value and then depreciated over their useful life. The entity receiving the asset would have incurred an obligation to deliver services or provide access to the asset in the future. A liability equal to the fair value of the asset would be recognised as deferred revenue. The obligation would be reduced and revenue recognised over the period in which the entity has an obligation to deliver services. The length of the period would depend on the contractual arrangements but it would not exceed the useful life of the asset.

PwC insight: Our response to IFRIC on its draft interpretation

Although PwC supports IFRIC in its efforts to reduce diversity in accounting treatments, we don't believe this interpretation is necessary because sufficient guidance on this issue already exists (for example, in AASB 118 *Revenue*, AASB 117 *Leases*, and Interpretation 4 *Determining whether an arrangement contains a lease*). Customer contributions given in exchange for an obligation to deliver services often reflect specific industry or regulatory features, and it is these features that cause diversity in accounting treatments rather than interpretations of the accounting literature.

If the draft interpretation is approved, the AASB will withdraw Interpretation 1017 because it would contradict the IFRIC's interpretation.

Resources to help you keep up to date with IFRS developments

- **IFRS News** summarises news from the International Accounting Standards Board (IASB) and International Financial Reporting and Interpretations Committee (IFRIC). It is published monthly at www.pwc.com/ifrsnews
- **AASB Action Alert** covers the activities of the Australian Accounting Standards Board and how it will respond to recent IASB pronouncements. It is usually published monthly and is available at www.aasb.com.au
- **IASB Update** covers the activities of the IASB and decisions reached at its most recent meeting. It is usually published monthly and is available at www.iasb.org
- **IFRIC Update** covers the activities of IFRIC and tentative decisions reached at its most recent meeting. It is usually published every two months and is available at www.iasb.org