

HKFRS News

Shedding light on the HKICPA's activities*

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HKFRS has converged with IFRS effective from 1 January 2005. Contents contained in this newsletter are relevant to both HKFRS preparers and IFRS preparers.

HKAS 36 *Impairment* – frequently asked questions

This newsletter is the second in the series highlighting frequently asked questions relating to the impairment process. It addresses when impairment tests need to be conducted, how the tests differ depending on the nature of the assets and how impairment is measured. It also looks at the determination of carrying amount and recognition of impairment losses.

Frequency of impairment tests

Q1. How frequently should impairment tests be conducted?

The frequency depends on the nature of the assets being tested. The standard requires all assets to be tested when there is an indicator of impairment. In addition, the following assets need to be tested annually even if no indicator of impairment exists: goodwill, indefinite-lived intangible assets and intangible assets not yet ready for use.

Q2. Should an entity perform the impairment test at interim balance sheet dates?

At each reporting date, including interim balance sheet dates, an entity is required to assess whether there has been any indication that an asset is impaired. If such an indicator exists, the asset must be tested for impairment.

Q3. How does an entity identify impairment indicators?

Impairment indicators can be internal (specific to the entity), such as sales below budgeted levels, or external, such as increases in market interest rates. Management should have an active process for considering factors affecting its business. Each entity typically has systems of management reporting in place that will assist in this process – for example, a commentary on the results of the month from management, which will identify the significant events in the month in question.

Example

A branch of a business in southern Asia, located close to a chemical factory was largely destroyed in an explosion. The insurance assessors are examining the damage, and management is confident that the full cost to rebuild plus compensation for loss of profits will be received.

Is the asset impaired in this case, given that it will be replaced?

Solution

Yes, the asset is impaired, as it has been destroyed. The replacement will be a new asset; the costs of construction are capitalised when it is built. Insurance proceeds for rebuilding costs are credited to income. The impairment loss is charged in the current period. Any insurance proceeds for the fixed asset and compensation for loss of profit can only be recognised when the recovery from the insurers is virtually certain.

Q4. Should management analyse the individual performance of individual assets or cash-generating units (CGUs), even when the company is overall profitable?

Management should consider the economic performance of the individual assets or CGUs to assess whether the asset or CGU is performing in line with expectations. The fact that an entity is profitable as a whole does not mean that an individual asset or CGU is not impaired.

Timing of impairment tests

Q5. When should an entity conduct annual impairment tests on goodwill and other intangible assets with indefinite useful lives?

Annual impairment tests may be performed at any time during the financial year provided that the testing is performed at the same time in subsequent periods. Different assets may be tested at different times of the year.

Q6. What are the advantages and disadvantages of performing an impairment test before the year-end?

The advantages are:

- Testing could be performed at a time when more resources are available to complete the tests;
- Annual impairment test process could be aligned with the budgeting process, which provides the data for value in use tests; and
- Any potential impairments and related disclosures could be assessed before the year-end accounts preparation process.

However, the risk with in performing a test before the year-end is that the impairment test will need to be re-performed if there is a subsequent trigger event.

Q7. How soon does goodwill acquired in a business combination need to be tested after an acquisition?

Goodwill should be tested for impairment in the year of acquisition. If the initial accounting or purchase price allocation cannot be completed in the year of acquisition, that initial accounting should be completed by the end of the twelve months from the date of acquisition. Without completing the initial accounting, the amount of goodwill would not be known. Once goodwill is known, it is allocated to CGUs and tested for impairment. In a situation where a December year-end entity acquires a business in May 2007 and purchase price allocation cannot be completed by December 2007, it would have up till May 2008 to complete this allocation. Hence, goodwill would not be known until then and the entity would have until December 2008 to allocate goodwill to CGUs and test it for impairment.

Q8. New goodwill arises from an acquisition that is allocated to a CGU (or group of CGUs) with pre-existing goodwill. If this occurs subsequent to the annual goodwill impairment testing date, how does it affect the CGU (or group of CGUs) to which the additional goodwill has been allocated?

Such a CGU (or group of CGUs) is re-tested for impairment before the end of the current year.

Example

An acquisition takes place in January 2006; the allocation of goodwill arising from this acquisition was completed in September 2006. The entity's annual goodwill impairment testing is performed in March of each year. When should the entity test goodwill for impairment?

Solution

The CGU (or group of CGUs) with the new goodwill allocated is tested for impairment before the end of the current period, December 2006.

Measuring recoverable amount

An asset is impaired when its carrying amount can not be recovered from its continued use or from its sale. The recoverable amount of an asset is compared to the carrying amount to determine if an asset is impaired. An asset's recoverable amount is the higher of its value in use (VIU) and its fair value less costs to sell (FVLCTS).

Q9. Is it necessary to calculate both VIU and FVLCTS when performing an impairment review?

It is not always necessary to calculate both measures in an impairment review. For example, there is no need to calculate VIU if FVLCTS can be reliably estimated and is higher than the carrying amounts being reviewed.

Value in use

An asset's or CGU's VIU is the present value of the future cash flows expected to be derived from the use of the asset or CGU and from its disposal. The VIU calculation is not a fair value calculation or a proxy for fair value. VIU is a prescribed form of cash flow model set down in HKAS 36 so that impairment testing is comparable.

Q10. What happens when the VIU was determined based on the most recent financial budgets/forecasts that had not been formally approved by management?

A non-approved business plan does not represent a reliable source of information, as it may be subject to change. Cash flow projections are based on the most recent financial budgets/forecasts approved by management to determine the VIU.

Q11. Should the most recently approved forecast be used without adjustment when determining VIU?

Adjustments to the forecasts may be necessary when determining the VIU. Forecasts must be based on reasonable and supportable assumptions that represent management's best estimate of the economic conditions over the asset's remaining useful life. Greater weight is given to external evidence.

Q12. The most recently approved forecasts assume that there will be a restructuring programme in the next financial year, however, no announcement has been made about the restructuring, and management has not started to implement such a plan. What adjustments, if any, does management need to make for the purpose of a VIU calculation?

When preparing a VIU calculation, the costs and benefits of the restructuring programme are ignored in the forecasts. The benefits (and costs) of a restructuring programme can only be taken into account when a provision for the programme is made in the financial statements. This is only permissible when the entity is demonstrably committed to the restructuring, that is, through implementation of the restructuring or a formal announcement to those affected to raise a valid expectation of such plan.

Q13. How does management assess when cash flow forecasts should terminate in order to assess VIU?

The general approach for a CGU that is a business with no predetermined or determinable lifespan is for the cash flow forecasts to include a terminal value. This, in effect includes cash flows for an indefinite period. If the CGU has a finite life, the cash flow forecasts must not exceed this finite life.

Q14. How is the appropriate pre-tax discount rate for a VIU calculation determined from a post-tax starting point?

The following two-step approach can be applied to derive iteratively the implicit pre-tax discount rate from post-tax data. This pre-tax rate is applied to the discounted cash flows that are the basis of the VIU:

Step 1:

From pre-tax cash flow projections, the expected actual tax cash payments are calculated to arrive at post-tax cash flows. These post-tax cash flows are discounted at an appropriate post-tax discount rate derived using information observable on the capital markets.

Step 2:

The pre-tax discount rate is derived by determining the rate required to be applied to the pre-tax cash flows to arrive at the result obtained in step 1 (i.e. same methodology used for computing an internal rate of return).

Fair value less costs to sell

When there is neither a binding sale agreement nor an active market, FVLCTS may be estimated as the amount that the entity could obtain from disposal of the asset in an arm's length transaction based on data from recent market transactions. Discounted cash flow techniques may be used in estimating the fair value of the asset.

Q15. Can FVLCTS be determined reliably in the absence of a binding sale agreement or active market for an asset?

It is not necessary to have actual market transactions to support a FVLCTS calculation, as long as the projected cash flows and discount rate are consistent with the assumptions that market participants would make. If comparable transactions in similar assets or businesses are available, they are used as market evidence. If such benchmark or comparable market transactions do not exist, any possible external evidence (e.g. growth rates, discount rates, etc.) is used to support the cash flow projections. Based on this, it is almost always possible to determine FVLCTS.

Q16. How is FVLCTS most reliably determined when it is based on a discounted cash flow technique?

Discounted cash flow techniques may be used in incorporating assumptions that market participants would use in estimating the fair value of the asset. The key assumptions underpinning the cash flow analysis are benchmarked against market evidence. Any differences in the assumptions in the cash flows used for the FVLCTS compared to those used in the VIU analysis are also considered for reasonableness, for example, restructuring or improvement-type capital expenditure that HKAS 36 does not allow in the VIU calculation may be added back in the discounted cash flows calculation to determine the FVLCTS.

Determination of carrying amounts

The comparison of the recoverable amount of an asset (i.e. FVLCTS or VIU) with its carrying amount to determine whether there is an impairment charge should be made on a consistent basis. FVLCTS and VIU use different assumptions and data. The carrying amounts are likely to differ for the comparison purposes with the recoverable amount (i.e. FVLCTS or VIU).

Q17. HKAS 36 requires the recoverable amount, determined under FVLCTS or VIU (or both) to be compared to the carrying amount of the asset or CGU to determine if there is an impairment.

So what then is the 'carrying amount'?

A carrying amount is the accounting book value of an asset or the book value of the relevant assets and liabilities of a CGU. Many CGUs are businesses, which will include both fixed assets and intangible assets, as well as working capital assets and liabilities and any other assets or liabilities. Only assets within the scope of HKAS 36 are included in the carrying amount. For example, equity securities accounted for as 'available for sale' would not be included in the carrying amount of a CGU because those investments have their separate cash flows. Carrying amount must include any allocations of corporate assets or goodwill.

Q18. Are the carrying amounts under FVLCTS and VIU always the same?

No. The components of VIU and FVLCTS are different. When comparing the recoverable amount (i.e. FVLCTS or VIU) with the carrying amount to determine whether there is an impairment charge, that comparison should be made on a consistent basis. The elements in both sides of the comparison should be determined on a like-for-like basis.

Q19. What categories of assets are included in the carrying amounts that are compared with the recoverable amount (i.e. FVLCTS or VIU)?

Only operating assets are included in the carrying amounts because the recoverable amount (i.e. FVLCTS or VIU) only includes operating cash flows for both calculations. Carrying amounts exclude financial assets, investment properties and any other non-operating asset.

Q20. Does the carrying amount of the CGU include any liabilities?

No. Liabilities are usually excluded from the carrying amounts (HKAS 36.76(b)). Sometimes the recoverable amount of the CGU cannot be determined without consideration of a particular liability – for example, a decommissioning liability for a power station is included in the carrying amount.

Q21. Should deferred tax liabilities be included in the carrying amount when the recoverable amount is based on VIU?

No. VIU is a pre-tax calculation, so deferred tax liabilities should be excluded from the carrying amount. On the contrary, FVLCTS is a post-tax calculation, so tax is considered and the carrying amount that is compared with FVLCTS includes the deferred tax liabilities.

Recognition of impairment losses

An impairment loss arising on a CGU is allocated first to goodwill allocated to the CGU, and second to the other non-monetary assets in proportion to their carrying amounts.

Q22. An impairment charge has been recognised on a CGU to which goodwill has been allocated. Which assets in the CGU are written down first?

The goodwill is written off before other intangible and tangible fixed assets are impaired. However, no asset is written down below the higher of value in use, fair value less costs to sell or nil.

Q23. Is it possible to have an impairment charge on a fixed asset in a CGU but not impair the goodwill attributed to the group of CGUs, which includes the CGU with the impaired fixed asset?

Yes. This results from step 1 of the following two-step approach:

Step 1:

Individual assets and smaller CGU's that are included in a bigger CGU are tested individually – excluding goodwill when there are indicators of impairment. This step allows the write-down of those assets that were impaired before the goodwill impairment. Management records any impairment on the CGU assets before the group of CGUs plus attributed goodwill are tested for impairment.

Step 2:

The bigger CGU that includes the individual assets and the smaller CGUs is tested for impairment. Management should compare the recoverable amount of the bigger CGU with its carrying amount that is reduced by the impairment loss already recognised in step 1. The second step may not result in the recognition of additional impairment.

Q24. Management uses key assumptions to assess the recoverable amount (i.e. VIU or FVLCTS) of a CGU to which significant goodwill has been allocated. Should information be disclosed in the financial statements on the key assumptions that management selected even if no impairment is recognised?

Yes. Management must disclose how the recoverable amount was estimated – whether VIU or FVLCTS. If the VIU was used, the following information should be disclosed:

- description of each key assumption underlying the cash flow projections and management's approach to determine it;
- the period over which management has projected cash flows (when greater than five years, reasons why that longer period is justified);
- the growth rate used to extrapolate cash flows; and
- the discount rate applied to the cash flow projections.

If FVLCTS was used, the methodology used to determine it should be disclosed. When the FVLCTS is not determined based on market prices, the following information must also be disclosed:

- a description of each key assumption used and management's approach to determining the key assumptions; and
- whether the assumptions are consistent with past experience or external data and if not, disclose the reasons.

The information is therefore essentially the same as that required for VIU.

Q25. Management uses key assumptions to assess the recoverable amount (i.e. VIU or FVLCTS) of a CGU that includes a significant acquired brand with an indefinite useful life. Management projects significant growth for the business in excess of that predicted by market analysts. Management concludes that no impairment charge should be recognised. What information should be disclosed in the financial statements on the key assumptions that management selected?

In addition to the information of the key assumptions to assess the recoverable amount, management should disclose the following information if a reasonably possible change in a key assumption underlying FVLCTS or VIU would cause an impairment to arise (HKAS 36.134(f)):

- the amount by which the CGU recoverable amount exceeds its carrying amount;
- the value assigned to the key assumption; and
- the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the CGU recoverable amount to be equal to its carrying amount.

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