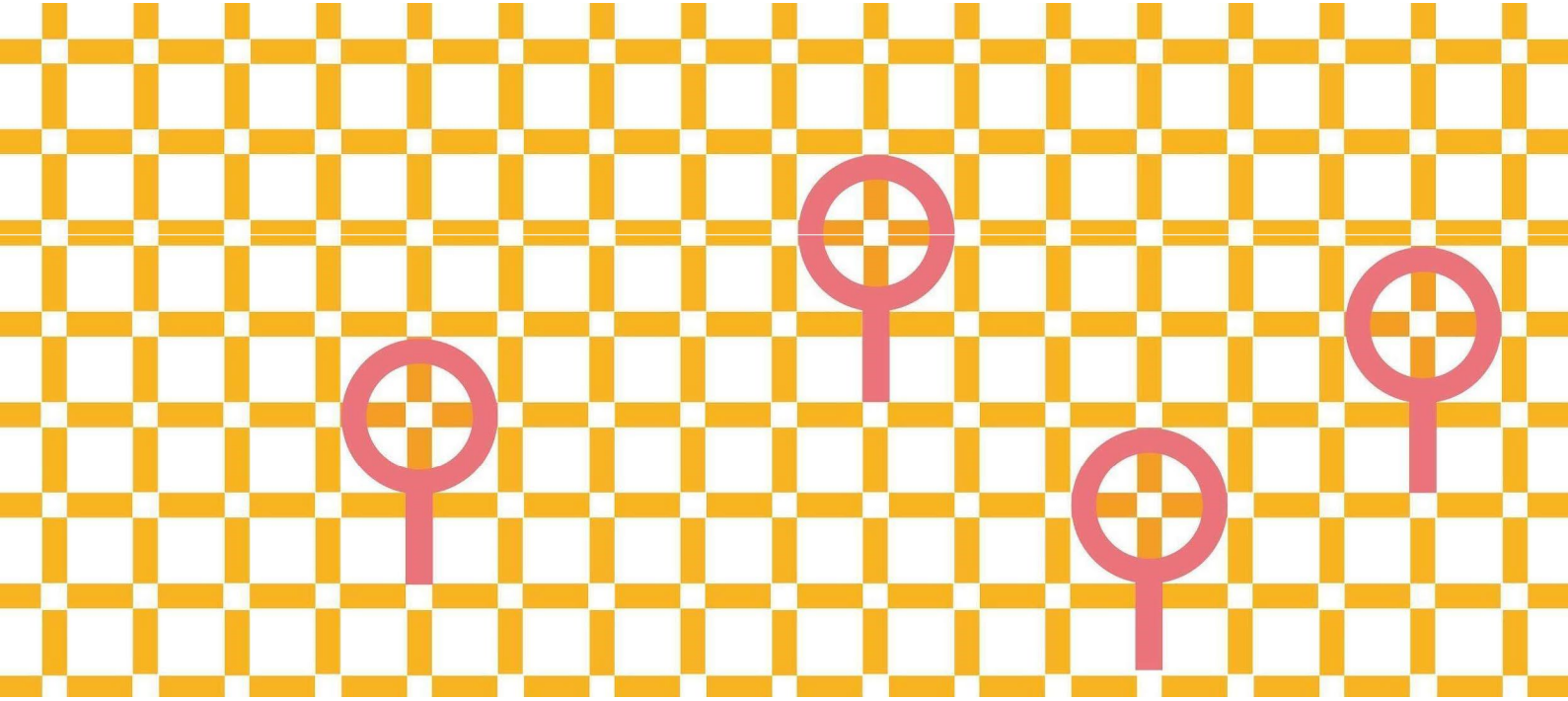

In brief

Impairment of non-financial assets – common mistakes

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Key Points

This In brief applies to all entities with significant non-financial assets that are required to be tested for impairment under IAS 36. Set out below is a refresher on some basic concepts on impairment of non-financial assets, and reminders on those aspects of the value in use (VIU) methodology where common mistakes are made.

What is the issue?

Impairment of assets is one of the main topics that arise most frequently in regulators' correspondence with companies. We expect the impairment tests and associated disclosures to remain an ongoing area of focus for users of financial statements as well as regulators, particularly in periods of heightened economic and geopolitical uncertainty.

What are matters to look out for?

1) Identification of CGUs (what to test)

Non-current non-financial assets (such as property, plant and equipment (PP&E), intangibles and right-of-use assets) are required to be tested for impairment at the level of each individual asset if there is an impairment indicator. If a recoverable amount cannot be

estimated for the individual asset, because it does not generate independent cash inflows, that asset should be tested as part of a cash-generating unit (CGU). The vast majority of assets are tested for impairment as part of a CGU or group of CGUs.

When identifying a CGU, it might be useful to look at how management chooses to monitor its operations, but this is not definitive. Determining a CGU should be a matter of fact, with a CGU being the smallest group of assets that generate largely independent cash flows – for example, individual hotels and retail stores usually generate income that is largely independent of others, so generally they form individual CGUs.

There are separate rules for goodwill. Goodwill is required to be tested for impairment at the lowest level at which management monitors it. If that is on an individual CGU basis, testing goodwill for impairment should be performed on that individual basis. However, where management monitors goodwill on the basis of a larger group of CGUs, the impairment testing of the goodwill should reflect this. The lowest level cannot be higher than the operating segment that it belongs to under IFRS 8. This would need to be considered even if the group does not apply IFRS 8. Management needs to exercise care that the entity's CGUs are appropriately disaggregated (that is, that they are not too large).

The identification of CGUs for the asset impairment test, and of groupings of CGUs for the testing of goodwill, often represents a significant judgement which should be clearly disclosed in the financial statements in accordance with IAS 1.

2) Impairment indicators (when to test)

Companies should assess, at the end of each reporting period (including interim periods), whether there is any indication that an asset might be impaired. We would expect many entities to have an impairment trigger in 2022 due to the ongoing impact of COVID-19, the effects of the Russian invasion of Ukraine, rising inflation and interest rates, climate-related issues and the general macroeconomic and geopolitical environment.

Assessment of impairment indicators might represent a significant accounting judgement to be disclosed in accordance with IAS 1. In times of uncertainty, even if management concludes that there are no impairment indicators, the rationale for such a conclusion would still need to be disclosed if it represents a significant judgement.

IAS 36 requires a bottom-up approach to impairment tests. If an impairment indicator is identified and it relates to a particular asset or CGU, that asset or CGU should be tested for impairment first. Under IAS 36, goodwill (given that it has indefinite life) is tested for impairment at least annually[1] and when there are impairment indicators. Goodwill impairment testing for groups of CGUs is performed after the individual assets and CGUs have been tested for impairment and potentially been written down.

3) The recoverable amount is the higher of the VIU and FVLCD

There are two methods to calculate recoverable amounts under IAS 36: fair value less cost of disposal (FVLCD); and value in use (VIU). FVLCD is a market participant approach, although almost always based on a discounted cash flow model. VIU is also a discounted cash flow model, with specific requirements and limitations on what cash flows can and cannot be included, as defined by the standard. The carrying amount of the asset or CGU is compared to the higher of FVLCD and VIU to determine any impairment charge.

Many companies (except for some niche industries) default to the VIU method, because it is often expected to provide a higher value; however, if the VIU model indicates an impairment, the FVLCD must be considered before any impairment is recorded.

[1] The annual impairment test for CGUs containing goodwill and other indefinite-life intangibles can be carried out at any time in the financial year, but it should be done at the same time each year.

4) The assumptions should be reasonable and supportable, based on approved budgets

Cash flow forecasts should be based on the latest management-approved budgets or forecasts. Assumptions made in the cash flows should be reasonable and supportable, and they should represent management's best estimate of the economic circumstances that will prevail over the remaining life of the asset or CGU. The cash flows to be used in a discounted cash flow prepared to determine FVLCD might well be different from those in a VIU calculation. Any differences in the cash flows used under the two methods should be considered for reasonableness.

Changes in the current economic climate might mean that assumptions that were reasonable a year ago might no longer be appropriate. Auditors are expected to challenge key assumptions within cash flows forecasts developed by management.

Greater weight should be given to external evidence when preparing and auditing cash flow forecast assumptions. For example, the cash flows/forecasts should be compared with external information, such as analyst reports, the views of other third-party experts and economic forecasters. It is possible to obtain analyst reports for most market sectors, and these should be considered as corroborative or contradictory evidence to evaluate management's key assumptions. Comparable transactions, and multiples implied in these transactions, can also be useful benchmarks.

Management often assumes that depreciation (for both PP&E and right-of-use assets) is a proxy for the outflows required to replace wasting assets in perpetuity models. In times of high inflation, depreciation is a poor proxy for future outflows. Care needs to be taken to ensure that replacement assumptions are appropriate. Inflation more generally needs to be carefully considered in the current models where these are prepared on a nominal basis (that is, including the impact of inflation), because not all costs experience the same exposure to inflation, and sales might only be impacted to the extent that inflation can be passed on to customers due to recessionary forces.

Specific challenges might relate to incorporating cash outflows for replacing leased assets on expiry of the leases into the impairment models.

> **N.B: If market capitalization is lower than the recoverable amount, challenge the assumptions**
>
> Market capitalisation below net asset value is an explicit trigger for an impairment test in the standard. If market capitalisation is lower than a VIU calculation, the appropriateness of the assumptions should be challenged.

5) Compare like with like – consider corporate assets, working capital, income tax, liabilities

Cash flows used in the recoverable amount should be consistent with the assets being tested in the carrying amount of the CGU. The impairment test should compare like with like. Corporate assets, working capital, income taxes and liabilities are key areas to consider.

Corporate assets and corporate overheads

The carrying amount of a CGU consists of:

- assets that are directly and exclusively attributable to the CGU; and
- an allocation of assets that are indirectly attributable, on a reasonable and

consistent basis, to the CGU including corporate assets and goodwill.

The cash outflows attributable to a CGU should include sensible allocations of corporate overheads. Allocation of corporate assets and allocation of overheads are linked. For example, if part of the carrying value of a brand is allocated to CGUs, any internal management charges paid by the CGUs relating to the use of that brand should be excluded from their cash outflows to avoid double counting. Generally, in a VIU test, all overheads should be included in the VIU model, either at the CGU level or at the overall group level; by contrast, in an FVLCD test, only those costs that are needed to run the business from the market participant's perspective would be included.

We see common errors on allocation of corporate assets to a CGU. Management might have failed to allocate corporate assets to CGUs on the basis that they are not individually impaired, or on the basis that allocation cannot reasonably be done, when in fact it can. We also see management not allocating corporate assets to an individual CGU (which, on occasion, might be correct), but then also not allocating them on an aggregated CGU level, resulting in the corporate assets being incorrectly excluded from the impairment assessment. There is an expectation that auditors will consider (and, if appropriate, challenge) management's CGU allocation, and that they will document this consideration.

Working capital

The carrying amount includes only the assets that generate future cash flows used in determining VIU. Many entities preparing cash flow forecasts for the purposes of impairment testing base their forecasts on the underlying cash flow forecasts for the business. These include cash flows arising from the settlement of working capital balances at the year end. The standards permit these entities to leave the forecasts unadjusted, provided that the carrying value of the CGU is increased by the amount of the working capital assets and reduced by the value of the working capital liabilities.

Income tax

Cash flows should exclude cash flows relating to tax losses, because these do not affect the recoverable amount of the CGU being tested. Current and deferred taxes are required by the standard to be excluded from VIU cash flows, but they should be included in FVLCD cash flows. In practice, post-tax discount rates and cash flows are often used in VIU models, which theoretically can give the same answer, but the need to consider deferred taxes makes this complicated. For guidance on how one might deal with deferred tax in a post-tax VIU model.

Liabilities

Cash outflows relating to obligations that have already been recognised as liabilities are generally excluded, because the related liability is excluded from the CGU, examples of such liabilities include debt, lease liabilities, pensions and provisions. A liability is only included in the CGU if the recoverable amount of the CGU cannot be determined without consideration of this liability. For example, decommissioning liabilities are often included, because they cannot be detached from the related assets. A common mistake is to deduct the liability (often discounted at a risk-free or borrowing rate) from the CGU assets and then to include the cash outflows in the VIU model (discounted at a WACC derived rate) which leads to an inbuilt buffer due to the differential discount rates. IAS 36.78 avoids this by requiring the carrying amount of the liability to be deducted from both the assets of the CGU and the cash flows of the VIU model, leading to a neutral impact.

6) Terminal value (extrapolate appropriately)

An asset with a finite life should have cash flows projected over that period. An asset or business with an indefinite life requires a terminal value in the cash flow forecast. This

represents what an investor might pay for the cash flows beyond the specific forecast period.

The terminal value is calculated either as an exit multiple or as a perpetuity formula, which takes the last year of cash flows and projects them indefinitely. An exit multiple should be based on market data, and it is applied to the cash flow in the last year of the projections. Whichever method is chosen, it is important that the cash flows used in the final year of the forecast are sustainable. Careful consideration is needed as to whether the business is cyclical, whether there is any mismatch between capital expenditure and depreciation, and/or whether cash flows into perpetuity are aligned with the future expectations of the operations of the business.

It is important to ensure that the forecast period is long enough (but typically not longer than five years) to achieve normalised growth and margin levels. If it is too short, the entire valuation will be dependent on the terminal value; any bias or error will be amplified.

We see common errors in that management overestimates the terminal values, due to overestimating the final forecast period. This overestimation is often attributable to the inclusion of one-off cash inflows in the terminal period, which are then extrapolated. The opposite effect would arise if exceptional outflows were mistakenly included in the final period. The final period must represent a steady state.

The long-term growth rate should be reasonable in comparison to long-term inflation expectations, where a cash flow is prepared on a nominal basis. Nominal long-term growth rates in excess of long-term nominal GDP growth imply that the business will eventually grow at a rate faster than the economy itself. This is unlikely to be appropriate. The long-term growth rate should be corroborated and/or challenged using external evidence.

7) Discount rates

The discount rate used should be the rate that reflects the specific risks of the asset or CGU and the time value of money. It is likely that different CGUs might warrant different discount rates - for example, some CGUs might be in different territories, or they might be more exposed to climate-related risks and this should be reflected in the discount rates for those CGUs - but the discount rate should not be adjusted for risks that have already been considered in projecting future cash flows. In most cases, however, discounted cash flow calculations based on approved budgets will not have been risk-adjusted, so an adjustment should be made to the discount rate. Management should also consider country risk, currency risk and cash flow risk. Although IAS 36 requires the use of pre-tax discount rates, in practice post-tax cash flows and discount rates are often used which then need to be reconciled to the pre-tax equivalents for disclosure purposes.

Foreign currency cash flows add complexity to the discount rate. The future cash flows are estimated in the currency in which they will be generated and then discounted at an appropriate rate for that currency. This discount rate might not be easy to determine, and it is likely to be different from the rate used for the remainder of the present value calculation, because it is country- and currency-risk specific.

The present value of the foreign currency cash flows should be translated at the spot rate at the date when the impairment review is being performed.

Management might have assessed a weighted average cost of capital (WACC) to be a reasonable proxy of the discount rate that represents the risk associated with the assets in the CGU and the time value of money.

The WACC should not reflect an entity's own capital structure

Management might use their WACC as a starting point in calculating the discount rate, but the standards require the entity-specific WACC to be adjusted - for example, to ensure that the discount rate is independent of the entity's capital structure. We see errors in management's composition of the WACC rate[2], in that the cost of debt is not based on recently achieved borrowings / leases, or it is determined from short-term loans, where the forecast period is much longer. We also see errors where the risk-free rate used relates to a territory different from the one in which the CGU operates, or where the entity beta is simply assumed to be 1 (that is, that the CGU moves exactly in tandem with the market overall).

The impact of increased economic uncertainty on a WACC

Where uncertainty in the economic environment has increased, the established methods for calculating the WACC should continue to be used. However, a reassessment of each input into the calculation and assessment of the overall result is needed. We would generally expect the inputs (such as long-term risk-free rates) used in the calculation of discount rates to increase compared to prior periods. [See GX In brief INT2022-20 'Have WACCs changed for December 2022 financial year ends?']

8) Allocation of impairment

Impairments must be recognised in the same order that the impairment testing is performed based on the bottom up approach described in Section 2 above:

i. individual assets;
ii. CGUs; and
iii. groups of CGUs (including goodwill).

When allocating impairment to a group of CGUs that includes goodwill:

iv. allocate impairment to the goodwill balance to reduce it to zero; and
v. allocate impairment to the other assets within the group of CGUs on a pro rata basis, based on the carrying amount of each asset.

Some companies, after fully impairing the goodwill, allocate the residual impairment solely to intangible assets, such as customer lists, brands or trademarks. This is not in line with IAS36 requirements. Any residual impairment that remains after full impairment of goodwill should be allocated to all non-current non-financial assets within the CGU or group of CGUs, including PP&E, right-of-use assets and intangibles (other than goodwill).

When allocating impairment to the assets in a group of CGUs, the individual assets should not be written down below the highest of:

vi. the FVLCD of the asset;
vii. the VIU of the asset; and
viii. zero.

9) Parent's separate financial statements

If impairment of goodwill is identified at the group level, this will most likely trigger, in the parent's separate financial statements, an impairment review of the parent entity's investment in the relevant subsidiaries. The VIU of an investment in a subsidiary would be determined by the present value of expected dividend receipts. The present value of the

[2] Note that the ration of debt to eqity, in order to dtrmine the WACC rate, should incorporate considerations of IFRS 16 lease liabilities, which are a form of financing.

estimated post-tax cash flows from the subsidiary's underlying assets might be used as a proxy for this if the subsidiary has no debt. Otherwise, the present value of expected cash flows should be reduced by the fair value of outstanding debt (both external and inter-company), in order to determine the net amount available for distribution.

Some companies test investments in subsidiaries and loans receivable from subsidiaries on a combined basis. This is not in line with the requirements in the standards, since the investments in subsidiaries, associates and joint ventures fall within the scope of IAS 36, while loans receivable fall within the scope of IFRS 9 for impairment testing. The IAS 36 test should be performed for the carrying value of investments only, and loans receivable from subsidiaries should be deducted from the present value of expected cash flows, to reduce the recoverable amount, as explained in the paragraph above.

10) Disclosures

IAS 36 and IAS 1 have extensive disclosure requirements.

Key assumptions, and management's approach to determining values assigned to each of those assumptions, should be disclosed. Key assumptions are those to which the recoverable amount is most sensitive (for example, assumptions on revenue growth and profit margins). If key assumptions differ from those indicated by external sources of information or past experience, an explanation is also required.

In times of higher uncertainty disclosure of the sensitivities is particularly important. Sensitivity disclosure requirements are twofold:

i. IAS 36.134 requires disclosure of *reasonably possible* changes in the value of key assumptions which reduce headroom to nil; and
ii. IAS 1.125 requires disclosure of information about the assumptions that have a significant risk of resulting in a *material adjustment* to the carrying amounts of assets and liabilities within the next *financial year*.

When does it apply?

While the accounting standard for the impairment of assets – IAS 36 – has not significantly changed recently, the level of complexity in applying the existing guidance has increased in recent years, due to heightened economic uncertainty.

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Ansprechpartner in Ihrer Nähe

Ulf Kühle
Tel: +43 1 501 88-1688
ulf.kuehle@pwc.com

Beate Butollo
Tel: +43 1 501 88-1814
beate.butollo@pwc.com

Medieninhaber und Herausgeber: PwC Österreich GmbH Wirtschaftsprüfungsgesellschaft, Donau City Straße 7, 1220 Wien
Für den Inhalt verantwortlich: Ulf Kühle, Beate Butollo
Kontakt: IFRS.Aktuell@at.pwc.com

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