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Pitfalls of Impairment Testing

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Testing for asset impairment is a challenging task for many businesses. Generally, an asset is impaired when its carrying amount exceeds its recoverable amount.

According to International Accounting Standard No. 36 (IAS 36), at the end of each reporting period, businesses shall assess whether there is an indication that an asset should be impaired. IAS 36 can complicate calculating the carrying and recoverable amounts of assets.

In this article, we discuss issues that arise during impairment testing.

When should an impairment test be conducted?

If there are any indications that an asset's carrying amount might exceed its recoverable amount, the recoverable amount shall be estimated. Irrespective of the indication, businesses should also conduct annual impairment tests for intangible assets with an indefinite useful life, and intangible assets not yet available for use by comparing the carrying amount with the recoverable amount. This test should be conducted at the same time each year.

Different intangible assets may be tested for impairment at different times. However, if an intangible asset is newly recognized during the current annual period, it should be tested for impairment before the end of that annual period.

Goodwill acquired in a business combination should also be tested annually for impairment.

What are the indicators for impairment?

Businesses should consider both external and internal factors when assessing whether the asset or cash generating unit (CGU) should be impaired. A CGU is the smallest identifiable group of assets generating cash inflows largely independent of the cash inflows from other assets or groups of assets.

External factors that could give rise to impairment include:

- a significant decline in the asset's market value – more than would be expected as a result of normal usage or the passage of time
- changes in technology, markets, economic regulations or the law
- an increase in the market interest rate
- when market capitalization is below the carrying amount of net assets.

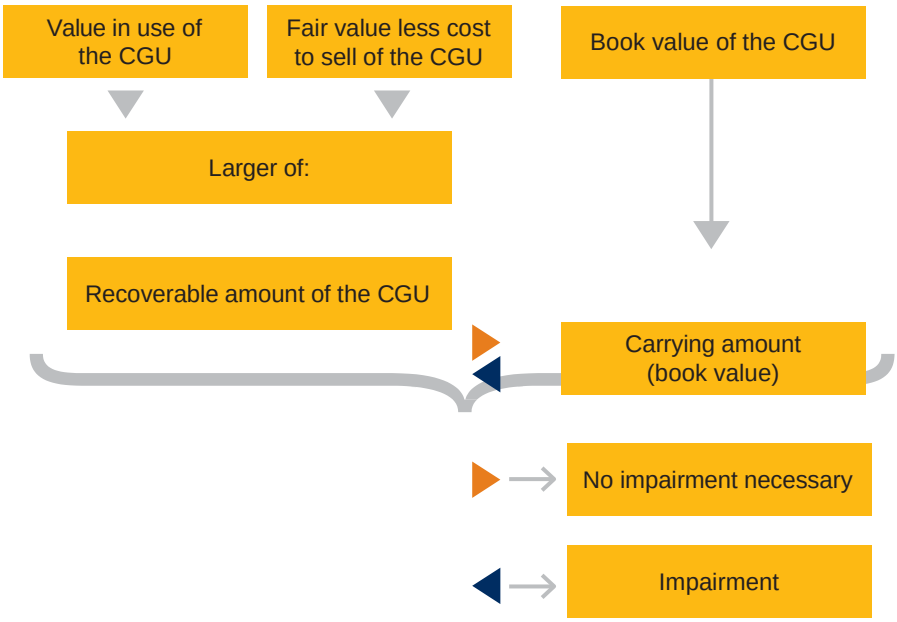
Internal factors that could give rise to impairment include:

- obsolescence or physical damage
- when the asset is part of a restructure or is held for disposal
- if the asset's economic performance has been worse than expected.

Measurement of the asset's recoverable amount

To estimate whether an asset has been impaired, the business should calculate the recoverable amount of the asset. If it is not possible to estimate the recoverable amount of the individual asset, the business should measure the recoverable amount of the CGU.

Figure 1: Recoverable amounts and testing for impairment



IAS 36 requires the recoverable amount to be calculated as the highest of the fair value less cost to sell (FVLCS) or value in use (VIU). If only one of the two is higher than the carrying value, no impairment should be made to the carrying value. It is not necessary to calculate both the FVLCS and VIU, as one of two is higher (see Figure 1).

Fair value less cost to sell

Fair value is the price that would be received if an asset was sold, or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Costs of disposal are incremental costs directly attributable to the disposal of an asset or CGU, excluding finance costs and income tax expense. A business does not need to intend to sell the applicable asset or CGU to apply the concept of FVLCS.

Value in use

VIU is the present value of the future cash flows expected to be derived from an asset or CGU. The following elements shall be reflected in the calculation of an asset's VIU:

- an estimation of the future cash flows generated by the asset or CGU
- expectations about possible variations in the amount or timing of those future cash flows
- the time value of money, represented by the current market risk-free rate of interest
- the price for bearing the uncertainty inherent in the asset
- factors such as illiquidity, which market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

Basis of cash flow estimation

Estimates of future cash flows should take into account:

- projections of cash inflows from the continuing use of the asset
- projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use), which can be directly attributed,

Figure 2: Calculating an asset's VIU

in USD '000	2013	2014	2015	2016	2017
Pre-tax cash flows	$ 250	$ 263	$ 276	$ 289	$ 304
VIU as per 1 January 2013 calculated using post-tax cash flows and a post-tax discount rate would be, as follows:					
	2013	2014	2015	2016	2017
Pre-tax cash flows	$ 250	$ 263	$ 276	$ 289	$ 304
Cost of asset	-1,000				
Tax 25%	188	-66	-69	-72	-76
Post-tax cash flows	438	197	207	217	228
Discount rate 10%	398	163	155	148	142
VIU	$1,006				
Pre-tax discount rate (grossed-up) = 10% / (1 - 25%) = 13.3%:					
	2013	2014	2015	2016	2017
Pre-tax cash flows	$ 250	$ 263	$ 276	$ 289	$ 304
Discount rate 10%	227	217	207	198	189
VIU	$1,038				
The 'appropriate' pre-tax discount rate using an iterative process:					
	2013	2014	2015	2016	2017
Pre-tax cash flows	$ 250	$ 263	$ 276	$ 289	$ 304
Discount rate 11.2%	225	212	200	189	179
VIU	$1,006				

or allocated on a reasonable and consistent basis, to the asset

- net cash flows (if any) to be received or paid for the disposal of the asset at the end of its useful life.

Estimates of future cash flows should not take into account:

- future restructuring to which a business is not yet committed
- improving or enhancing the asset's performance
- cash inflows or outflows from financing activities
- income tax receipts or payments.

Pre-tax approach

To calculate the VIU, IAS 36 requires businesses to use pre-tax cash flows and a pre-tax discount rate. However, the opportunity cost used in valuations is often a post-tax figure. Valuers also often prefer to use post-tax discount rates and cash flows to determine the recoverable amount as there are a number of issues in calculating a pre-tax discount rate.

Figure 3: Effect of purchase price allocation on asset carrying amounts
**PPA: purchase price allocation ** Dollar amounts = US$,000*

Balance sheet	Before PPA	PPA effects	After PPA	Include in carrying amount	Carrying amount
Goodwill	$100	$1,644	$1,744	Yes	$1,744
Intangible assets	20	1,016	1,036	Yes	1,036
Tangible assets	200	18	218	Yes	218
Financial assets	20	54	74	No	
Fixed assets	340	2,732	3,072		
Inventory	100	12	112	Yes	112
Receivables	460	0	460	Yes	460
Cash and cash equivalents	20	0	20	Yes	20
Deferred tax asset	160	0	160	No	
Occurred from PPA	0	2	2	No	
Current assets	740	14	754		
Total assets	**$1,080**	**$2,746**	**$3,826**		
Equity	$360	$2,426	$2,786	No	
Provisions	100	0	100	Yes / No	
Tax provisions	50	0	50	No	
Other provisions	10	0	10	Yes	10
Long-term liabilities	160	0	160		
Bank loans	330	0	330	No	
Payables	130	0	130	Yes	130
Deferred tax liabilities	100	0	100	No	
DTL occurred from PPA	0	313	313	Yes / No	
Other liabilities	0	7	7	Yes	7
Short-term liabilities	560	320	880		
Total liabilities	**$1,080**	**$2,746**	**$3,826**		
Carrying amount					**$3,443**

According to IAS 36, discounting post-tax cash flows at a post-tax discount rate should lead to the same result as discounting pre-tax cash flows with a pre-tax discount rate.

In this case, the pre-tax discount rate must be based upon the post-tax discount rate result, whereas the post-tax discount rate is adjusted to ascertain the specific amount and timing of the future tax flows.

When the pre-tax discount rate is grossed up with the applicable tax rate, it is likely that the pre-tax VIU and the post-tax VIU will differ due to the variability of the effective tax rate.

Therefore, we suggest the appropriate approach would be to derive the pre-tax discount rate using an iterative process in which the effective discount rate is determined using the pre-tax cash flows and post-tax VIU.

Deferred tax liabilities

If a company acquires a CGU at a fair value of US$5 million and a zero tax base, the company is confronted with the fact that the acquisition creates a deferred tax liability. This occurs when the asset is amortized only for commercial reasons.

The deferred tax liability takes goodwill into account, which increases the value of net assets. Therefore, applying a tax rate of 25% would increase goodwill to US$1.25 million and the value of net assets would total US$6.25 million.

In this example, if a company needs to perform an impairment test, IAS 36 indicates that the VIU should be calculated on a pre-tax basis. However, on a pre-tax basis, the carrying amount estimate of US$6.25 million may unnecessarily trigger impairment – as the carrying amount is greater than the recoverable amount.

Therefore, in this situation we argue instead for a post-tax approach, where the carrying value is adjusted for the deferred tax liability and the company avoids the need for asset impairment.

Conclusion

When performing impairment tests, several factors should be kept in mind. A common issue is whether the discount rate and cash flows should be treated in a pre- or post-tax manner. In this article we have taken a post-tax approach. Businesses should carefully calculate the carrying amount when dealing with the deferred tax liabilities that may arise from the acquisition of an asset.

For more information:

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