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Impairment Testing of Assets

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Introduction

Our previous newsletter discussed subsequent accounting in a business combination. This month we discuss the technicalities in impairment testing of assets: tangible as well as intangible, in accordance with Ind AS 36: Impairment of assets[1], IAS 36: Impairment of assets[2], ASC 350: Intangibles - Goodwill and others[3] and ASC 360: Property, Plant and Equipment[4] (jointly referred to as "reporting standards").

IMPAIRMENT TESTING OF GOODWILL AND INDEFINITE LIVED INTANGIBLES

Guidance pertaining to impairment testing of goodwill and other indefinite lived intangible assets is covered under ASC 350, Ind AS 36 and IAS 36. The impairment testing process under these standards is based on a comparative approach wherein the carrying value of the asset is compared to its fair value (under ASC 350) or recoverable value (under Ind AS/IAS 36). If the carrying value of the asset in question is higher than the fair value or recoverable value, the asset is said to be impaired and an impairment loss is recognized.

Ind AS/IAS 36

- **Impairment test**

IAS 36 and Ind AS 36 prescribe a single step impairment process for determining impairment loss. The premise of the test is to calculate the recoverable value of the of the asset or cash generating unit and compare it with their carrying amount.

The recoverable value under Ind AS/IAS 36 is defined as higher of the value in use and fair value less costs to sell. Fair value less costs to sell is defined as, "*the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal*". Value in use is defined as, "*the present value of the future cash flows expected to be derived from an asset or cash-generating unit*"

If the cash flows of a particular asset cannot be separately identified, then in accordance with IAS 36 and Ind AS 36 the cash generating unit to which asset belongs should be tested for impairment. A cash generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets.

It is pertinent to note that it is not necessary to calculate both i.e. fair value less costs to sell as well as the value in use if either of the two exceeds the carrying value of the asset.

[1] Ind AS 36: Impairment of assets issued by the Ministry of Corporate Affairs, India
[2] IAS 36: Impairment of assets issued by International Accounting Standards Board
[3] ASC 350: Intangibles: Goodwill and other issued by Financial Accounting Standards Board
[4] ASC 360: Property, plant and equipment issued by Financial Accounting Standards Board

- **Computation of fair value less costs to sell and value in use**

Fair value under Ind AS 36 is determined in accordance with Ind AS 113: Fair value measurements i.e. *Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*

Per Ind AS/IAS 36, the best estimate of fair value less cost to sell is a price in a binding sale agreement in an arm's length transaction, adjusted for incremental costs directly attributable to the disposal of the asset. The standards also discuss the various alternative sources of information that could be referred for determination of fair value less costs to sell such as:

- If the asset is traded in an active market, its market price less cost of disposal
- The amount that an entity could obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties less costs of disposal

For the purpose of calculation of value in use, the standards require that the following should be reflected in the calculation:

- Estimate of the future cash flows estimated to be derived from the asset
- Expectations about possible variations in the amount or timing of cash flows
- Time value of money
- Price of bearing uncertainty inherent in the asset
- Other factors such as illiquidity

Ind AS/IAS 36 specifically state that the cash flow projections used to compute the value in use must exclude any estimated inflows or outflows expected to arise from future restructurings or improvement/enhancements to the asset's performance. Thus, it requires cash flows to be based on the existing state of the asset.

- **Treatment of impairment loss under Ind AS/IAS 36**

If the recoverable amount of the asset is less than the carrying amount, the difference is considered as impairment loss and the carrying amount of the asset is reduced by that amount. The corresponding treatment of the impairment loss is given in the profit or loss account. However, if the asset has been revalued in the past, the impairment loss shall first be set off against the revaluation reserve and the balance if any, shall be debited to the profit or loss account.

When a cash generating unit has been tested for impairment, an impairment loss is recognized only when the carrying amount of the cash generating unit exceeds its fair value. The loss is allocated to reduce the carrying amounts of the assets in the following order:

- Reduce the carrying amount of any goodwill allocated to the cash generating unit
- Allocated to other assets of the group pro-rata on the basis of their carrying amounts. Such reductions are treated akin to impairment of individual assets as discussed above.

ASC 350

Per ASC 350, entities have an option to perform a qualitative assessment test to determine whether the asset/goodwill is impaired. If after the assessment, the entity determines that it is more likely than not that the indefinite lived asset/goodwill is impaired, then the two-step process as discussed below is necessary.

ASC 350 prescribes a two-step process to test the asset for impairment:

Step 1: Calculate the fair value of the reporting unit and compare it with the carrying amount which includes goodwill.

Step 2: In the event when the fair value is lower than the carrying amount of the reporting unit, the fair value is allocated to all the assets by performing a purchase price allocation and the implied value of the goodwill is recognized in the same way as it is recognized in a business combination. If the implied value of goodwill is lower than the carrying value, goodwill is said to be impaired, and the loss is to be recorded in the profit and loss account

A reporting unit is defined as an operating segment or a level below operating segment. Operating segment is defined under ASC 280 to have the following characteristics:

i. The component engages in business activities from which it may recognize revenues and incur expenses.
ii. The operating results of the component are regularly reviewed by the entity's chief operating decision maker.
iii. Discrete financial information about the component is available.

- **Update to the two-step process**

The two-step process prescribed above will now be replaced by a one-step process known as quantitative impairment testing via ASU 2017-04 issued by Financial Accounting Standards Board (FASB) dated January 26, 2017. The update does away with the purchase price allocation exercise required in the event of an impairment loss recognized and simply prescribes to reduce the carrying amount of the goodwill by the impairment loss. In any case, the amount of impairment loss shall not exceed the value of goodwill.

The applicability of this revision is as follows:

- For public business entities that are SEC filers, fiscal years beginning after December 15, 2019
- For public business entities that are not SEC filers, fiscal years beginning after December 15, 2020
- For all other entities, including not-for-profits, fiscal years beginning after December 15, 2021

Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017.

- **Computation of fair value of reporting unit**

The fair value of the reporting unit per ASC 350 must be consistent with the definition of fair value per ASC 820. Thus, all the underlying assumptions of fair value such as market participant assumptions need to be taken into consideration when determining fair value of the reporting unit in accordance with ASC 350.

Other matters to be considered in impairment testing of goodwill/indefinite lived intangible assets

➢ **Level of cash flows**

Ind AS and IAS 36 require the use of pre-tax discount rates for the purpose of the valuation analysis. However, practically due to the application of the Capital Asset Pricing Model, the cost of equity derived is a post-tax cost. Thus, entities calculate the value in use or the fair value using post tax rate and post-tax cash flows. The pre-tax rate is then computed by applying an iterative process based on the understanding that the pre-tax cash flows at a pre-tax discount rates and the post-tax rates with the post-tax cash flows should result in the same value conclusion, provided the amount and the timings of future tax flows are taken into consideration.

ASC 350 does not provide any specific guidance relating to the level of cash flows and discount rates and states that there should be consistency in level of cash flows and the discount rate being used.

➢ **Allocation of assets and liabilities to the unit**

When a reporting unit/cash generating unit is being tested for impairment, it is important to determine which assets/liabilities should be included while determining the carrying value of the reporting unit/cash generating unit. While such an ascertainment might be straight forward for certain assets, other assets may need further analysis for the same. The reporting standards prescribe factors that should be considered when deciding on the allocation of assets/liabilities to the reporting/cash generating unit.

Under ASC 350, the assets acquired and liabilities assumed are allocated to a reporting unit as of acquisition date if following criteria are met:

- The assets or liabilities relate to the operations of a reporting unit.
- The assets or liabilities will be considered in determining the fair value of the reporting unit.

For the purpose of allocating assets and liabilities to the cash generating unit, Ind AS/IAS 36 state that the cash generating unit should:

- Include all assets that can be attributable directly or allocated on a reasonable basis to the cash generating unit and will generate future cash inflows
- Not include the carrying amount of any liability unless the recoverable amount of the cash generating unit cannot be determined without consideration of this liability.

➢ **Allocation of goodwill to the unit**

Goodwill recognised in a business combination under ASC 805/IFRS /Ind AS 103: Business Combinations, should be allocated among the reporting or cash generating units. The allocation of goodwill is necessary in case if an impairment of goodwill is determined and such loss is to be allocated among to cash generating units in case of IAS/Ind AS 36 as or reporting unit under ASC 350.

Goodwill that is acquired on a business combination shall be allocated as on the acquisition date to the units of the acquiring entity that are expected to benefit from the synergies of the combination even though the assets acquired and liabilities assumed may not be assigned to that unit.

➢ **Reversing an impairment loss**

Reversal of impairment loss	IAS 36 and Ind AS 36	ASC 350
Goodwill	Prohibited	Prohibited
Other assets	Allowed	Prohibited

IMPAIRMENT TESTING FOR LONG LIVED ASSETS

Guidelines for impairment testing for long-lived intangible assets are covered under Ind AS & IAS 36 and ASC 360: Plant, Property and Equipment. The process of impairment testing of long-lived assets under Ind AS and IAS 36 is the same as that defined for goodwill and indefinite-lived intangible assets i.e.:

- Determination of recoverable value which is higher of the value in use or fair value less costs to sell
- Comparison of recoverable value with carrying value
- If carrying value is higher than recoverable value, determination of impairment loss by comparing carrying value with fair value

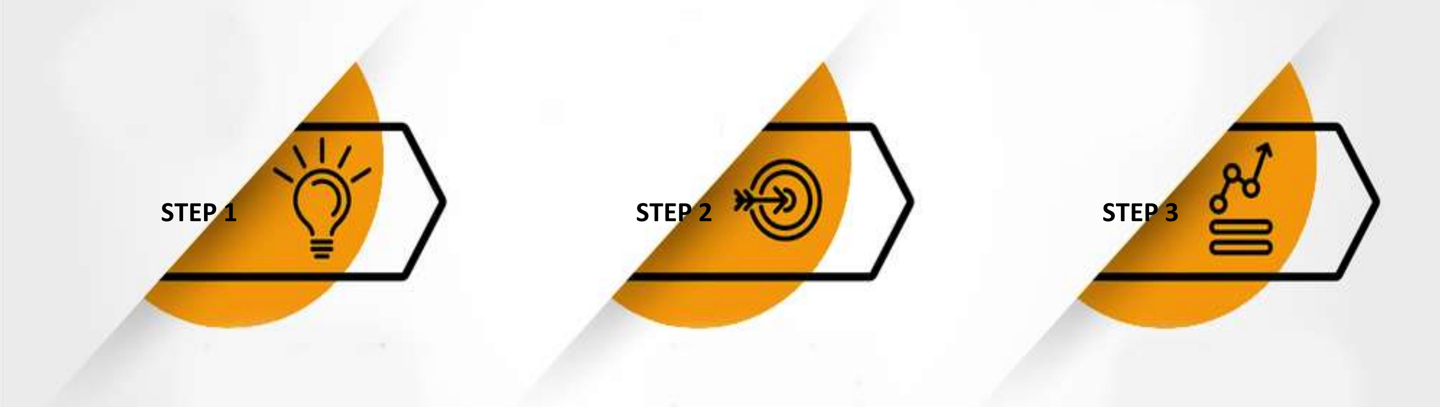
ASC 360 provides specific guidance for impairing long lived assets. This guidance is contained in subsection 360-10 of the standard titled “Impairment or Disposal of long-lived assets”.

ASC 360 states that if the carrying amount of the long-lived asset is determined to be not recoverable, the asset is said to be impaired. Carrying amount of the asset is said to be not recoverable if it is higher than the sum of undiscounted cash flows attributable to the asset / asset group.

If the cash flows generated by a long-lived asset cannot be individually identified, the asset shall be grouped with other asset or liabilities at the lowest level for which identifiable cash flows, independent of other assets can be recognized.

- **Impairment testing**

The process of recognizing and measuring an impairment loss under ASC 360 is a 3-step process as follows:



STEP 1

Indicators of impairment

A long-lived asset must be tested for impairment only when events or circumstances indicating that the carrying amount might not be recoverable exist. Examples of such indicators include significant decrease in market price of the asset, adverse change in legal factors or business climate affecting the value of the asset etc.

STEP 2

Test for recoverability

In case of presence of circumstances indicating impairment, the recoverability test is performed wherein the net undiscounted cash flows expected to be generated from the use of the long-lived asset and its eventual disposal. Cash flow estimation is based on the life of the long-lived asset or the primary asset in the group. Cash flows should also take into account the possible future outflows that are likely to occur during the life of the asset. The carrying amount of the asset/group of assets is then compared with the sum of undiscounted cash flows and if the former is higher, the asset is said to be impaired.

STEP 3

Measurement of impairment loss

If the undiscounted cash flows used in the recoverability test are less than the long-lived asset’s (group’s) carrying amount, an entity is required to determine the fair value of the long-lived asset (group) and recognize an impairment loss if the carrying amount of the long-lived asset (group) exceeds its fair value. The fair value for this purpose shall be determined based on principles consistent with ASC 820: Fair value measurements.

➢ **Order of impairment testing**

In certain situations, an indefinite-lived intangible asset, long-lived asset as well as goodwill of the reporting unit that comprises these assets need to be tested for impairment at the same time. The order of impairment testing is as follows:

- Impairment testing of indefinite lived intangible asset
- Impairment testing of long-lived asset
- Goodwill impairment testing

➢ **Frequency of impairment testing**

While long-lived assets need to be tested for impairment only when circumstances indicating impairment exist, goodwill or assets with an indefinite life should be tested on an annual basis. The annual impairment test for such assets can be performed at any time during the fiscal year provided the test is performed at the same time every year. The goodwill of a unit can be tested for impairment between the annual tests in case of any event or circumstances indicate that it is more likely than not that an impairment exists.

Goodwill and other intangible assets may be tested between annual test dates if there is:

- A significant adverse change in legal factors or in the business climate
- An adverse action or assessment by a regulator
- Unanticipated competition
- A loss of key personnel
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of
- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a unit.

The importance of impairment testing cannot be undermined given the increasing number of companies turning to bankruptcy courts and also the increasing number of intangible asset bubbles being burst by the regulators in the current corporate scenario. Impairment testing is gradually but steadily graduating from being the exception to the rule.

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