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Impairment of Non-Current Assets Under Different Frameworks

Introduction

General purpose financial statements of a Company that are so often used by various stakeholders such as the shareholders, prospective investors, regulators, employees, lenders amongst others, are to be mandatorily prepared in accordance with the requirements of a financial reporting framework. Such a framework is required to ensure standardization (to the extent possible) and that these statements are not misleading. The financial reporting framework varies across the globe. In India itself, we have two different sets of standards, one for the listed and high net worth companies in the form of Indian Accounting Standards (Ind AS) and other the being Accounting Standards (AS) for other entities. Many countries across the globe prepare financial statements using International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). Ind AS is a converged version of IFRS. US Generally Accepted Accounting Principles in the form of Accounting Standard Codification (ASC) is also seen as a rigorous requirement on the preparation and presentation of financial statements.

Conservatism to a varied extent is something that connects different financial reporting frameworks. In this context, the accounting fraternity is made to ensure that the assets are not overstated in the balance sheet of the reporting entity. In today's article, we will discuss the requirements related to the impairment of non-current assets, the Property, Plant and Equipment (PPE) and Intangible assets.

Why Impairment?

Non-current assets, i.e., PPE and Intangible assets, are usually carried in the balance sheet using the cost model, i.e., these are reported at an amount that is equal to the historical cost less the accumulated depreciation, where the accumulated depreciation represents the monetary value of the benefits already used by the entity out of the total cost incurred on such assets. Financial reporting frameworks often permit using a revaluation model instead of a cost model, whereby the historical cost is replaced by a revalued amount, which is based on the fair value of asset. Revaluation is not always permissible; for instance, AS does not allow the revaluation of the intangible assets.

Depreciation of an asset is estimated based on how much of the asset benefits have been consumed and how much is yet to be consumed. Internal and/or external factors might indicate that an asset is overstated in the books of accounts, triggering a need for impairment testing.

Impairment Triggers

Management of the company needs to perform detailed impairment testing if any of the impairment triggers exist. These could be in the form of internal sources of information such as, obsolescence or physical damage of an asset, plans to discontinue the use of the asset, or indicators that the economic performance of an asset could be worse than expected. External sources of information could be changes in the technological, market, economic, or legal environment, an increase in market interest rates, or the carrying amount of the entity's net assets being more than the market capitalization of the entity.

Under Ind AS, Goodwill, as recognized in the books (from business combinations), is to be mandatorily tested for impairment regardless of the indicators. This is because goodwill is not amortized under Ind AS and IFRS. Intangible assets under development are also subject to mandatory impairment testing. Under USGAAP, the change in market interest rate is not an indicator of the impairment. This is because of the difference in computation methodology.

Level at which Impairment Assessment is to be Performed

An impairment assessment is required to be performed at the individual asset level. However, some assets do not generate cash flows individually, so management, in such cases, needs to identify a Cash Generating Unit (CGU) to perform impairment testing. CGU is the smallest identifiable group of assets that generates cashflows, largely independent of the cash inflows from other assets, or groups of assets.

Goodwill is always tested for impairment at a CGU level. Under Ind AS and IFRS, management must allocate goodwill to the CGUs that will benefit from the business combination. This allocation does not necessarily follow the ratio of allocation of tangible assets.

Identification of CGU requires management to use judgment.

Impairment Assessment and Calculations

For the impairment assessment, the company needs to compare the book value of asset/CGU with the recoverable amount of the asset/CGU. If the recoverable amount is lower than the book value, an impairment loss exists, which is required to be charged to the P&L. However, for an asset under the revaluation model, the impairment loss is treated as a revaluation decrease and is adjusted against the balance in the revaluation reserve to the extent permissible.

Recoverable amount is calculated as higher of 1) Value in Use and 2) Fair value less cost of disposal. Value in use is the present value of future cash flows from the asset/CGU. The estimates for the future cash flows include the cash inflows and outflows to be derived from the continuing use of the asset and from its ultimate disposal.

These should be based on the present condition of the asset and should consider including the effect of possible variations in the amount or timing. The cash flows should be based on the most recent financial budgets/forecasts, and the projections should be based on assumptions that are reasonable and supportable. Generally, the forecasts would be available for a period no longer than five years, the cash flows beyond this period are extrapolated using a steady/declining growth rate. Due to the judgments involved and the sensitivity, these are often a subject matter of scrutiny by the auditors.

Fair value less cost of disposal is based on the price that will be received from the sale of an asset in an orderly transaction between market participants, net of the disposal costs to be incurred by the entity. There are various acceptable models for calculating the fair value of the asset. Value in use is specific to the entity, but fair value is based on the market participants' approach.

Management would generally seek support from an outside valuer to assess the fair value of the asset. However, if it is evident that the value in use of the asset is higher than the book value, any assessment of the fair value would prove to be redundant.

The approach to the impairment calculations under USGAAP differs from the one noted above. USGAAP follows a two-step approach. Initially, the book value of the asset is compared with the undiscounted cash flows. Step 2 gets triggered only if the book value is higher than the undiscounted cash flows, in that case, impairment loss is measured as the difference between the carrying amount and fair value. If the book value is lower than the undiscounted cash flows, no impairment loss is required to be provided. However, in that case, management would be required to review the estimates of depreciation method and useful life of the asset.

Reversal of Impairment Loss

Ind AS and IFRS permit the reversal of impairment losses (except for goodwill) if the indicators that caused the impairment have reversed. In such a case, the asset can be written up to the lower of:

- The revised recoverable amount and
- The carrying amount had there been no impairment in the first place.

Reversal of impairment loss on goodwill will amount to recognition of self-generated goodwill as against acquired goodwill and are therefore not permitted. Any increase in the value in use of an asset purely on account of the passage of time would not result in a reversal of impairment loss. (for example, cash flow remaining the same, the present value will increase as we close to the maturity; this cannot, however, result in reversal of impairment loss). Under the USGAAP, reversal of impairment losses is prohibited. This is because, at the first place, the impairment losses are triggered only after a rigorous condition i.e., carrying amount of the asset exceeding the undiscounted future cash flows from the asset.

Management Readiness

Following could serve as key reminders for the management, in relation to impairment:

- Look out for any indicators of impairment of asset. Timely action in this regard would ensure that financial statements are prepared and audited on time.
- Use judgment and knowledge of business to identify CGU and allocate goodwill to CGU.
- Document the impairment calculation. Get internal sign-offs wherever applicable.
- Base the value in use calculations based on the budgets/forecasts. Make sure these assumptions are consistent with each other and the budgets used elsewhere.
- Get assistance from a registered valuer for the fair value calculation on a timely basis incorporating the requirements of the financial reporting framework.
- Share these calculations with the auditors on a timely basis to avoid any last minute questions/challenges.

Conclusion

Requirements in the financial reporting framework towards the impairment of non-current assets try to ensure that the assets in the books are not overstated. Management can perform the impairment calculation a little before the year-end date to avoid the pressure on other year-end activities; a regular assessment and being aware of the requirements of the financial reporting framework would assist in this regard. Auditors would generally take a lot of interest in these areas, so having the calculations and assumptions documented would help in audit being conducted smoothly.

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