Accounting standard 28
Impairment

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Analogous standards

- IAS 36
- FAS 144
- IFRIC 10 on Interim Financial Statements and Impairment

Purpose of the standard

- To state assets at their recoverable values, that is, to recognise an impairment loss if recoverable value of an asset is reduced
  - Recoverable amount is higher of net selling price or value in use
- When is impairment tested
  - End of each accounting period – balance sheet date
- Depreciation and impairment
  - Meaning:
    - Depreciation is amortisation, that is, systematic allocation of the depreciable amount over the useful life of the asset
    - Impairment is recognition a decline in the recoverable value of asset
  - Periodicity
    - Since depreciation is amortisation, it is written off in every accounting period
    - Impairment is recognised only when there is indication of impairment
    - Hence, impairment is exceptional
  - Tax admissibility
    - Depreciation is accepted for tax purposes
    - Impairment is not accepted for tax purposes
- Impairment and fair valuation
  - Impairment is not fair valuation
    - Fair values may go up; impairment is only downward valuation
  - Fair valuation applies to assets and liabilities
    - Impairment applies to assets only

Scope exception

- Inventories
- Financial assets
  - AS 30 contains those provisions
- Assets arising out of Construction contracts
- Deferred tax assets
- Applies to assets carried at cost or carried at revalued values
  - Revaluation done as per AS 10, Accounting for Fixed Assets

Indicators of impairment

- All the factors below are illustrative
- External indicators
  - Significant Decline in market value of the asset, other than due to natural wear and tear
  - Significant adverse changes have taken place in the technological, market, economic or legal environment
  - Increase in interest rates/rates on investments which would increase discounting rates, affecting value-in-use of assets
  - Carrying amount of net assets is more than the market capitalisation of the entity
- Internal indicators
  - Evidence of physical damage or technological obsolescence of the asset
  - Significant internal developments have taken place/expected affecting the value of the asset, eg., plans to restructure, whereby the asset in question would be rendered useless
  - internal evidence suggests that economic performance of the asset is worse than expected (what sort of internal evidence – next slide).

Internal evidence indicating impairment

- Operating costs are higher than expected
- Net cashflows or operating profits are lower than expected
- Significant decline in budgeted net cashflows or increase in losses from the asset
- Are we testing for impairment every period:
  - If in the past, impairment tests have been carried out, then, unless there is change in circumstances indicating impairment, there is no need to re-test for impairment

Establishing recoverable amount

- Do we look at individual assets or group of assets
  - If the asset generates cashflows largely independently, individually
  - Otherwise, cash generating unit (group of assets)
- Net selling price
  - Selling price minus cost of disposal
  - Bid prices are usually taken
- Value in use
  - Estimating future cashflows from continuing use of the asset and its ultimate disposal
  - Applying appropriate discounting rate for present valuation
- Cashflows include
  - Cash inflows from the asset
  - Outflows needed to generate the cash inflows
    - Including allocated overheads
  - Disposal value
- Estimating future cashflows
  - Based on realistic budgeted estimates
  - Budgets typically for 5 years, beyond that, the values are extrapolated, with a steady or declining growth rate
  - Future cashflows should include cashflows based on existing state of the asset, excluding effect of any capital expenditure or restructuring

Use of discounting rates

- If estimated cash inflows have been inflation-adjusted, that is, inflationary increase in values has been assumed, the discounting rate should also be inflation-adjusted
- Financial costs should NOT be considered as a part of the cashflows
  - Discounting rate itself takes care of time value of money
- Cashflows should be pre-tax
  - Discounting rate should also be pre-tax
- In case of cashflows in foreign currencies
  - Discounting rate should be the appropriate rate for that currency
- Establishing discounting rate (Para 47-55)
  - Expected rate of return of investors, on pre-tax basis, commensurate with the risk of the asset
  - If investors' expected rate not available, as proxies
    - WAC of the entity
    - Incremental borrowing rate
    - Other market borrowing rate
  - These rates should be risk-adjusted
    - Excluding those risks for which the cashflows have already been adjusted
  - The discounting rate is independent of the way the asset is funded
  - Usually a single discounting rate is used
    - That is, yield curve consideration do not apply to discounting the value in use

Impairment losses for individual assets

- Impairment loss is recognised by
  - Reducing the asset to the recoverable amount
  - Recognising impairment loss in P/Ls
- In case of assets carried at revalued prices (AS 10), the impairment loss should be reduced from revaluation reserve
- Post impairment, the reduced carrying value of the asset is allocated over useful life for computing depreciation
- Recognition of impairment will also lead to recognition of deferred tax asset/liability

Impairment losses for cash generating units

- Where the recoverable amount of individual assets cannot be determined, impairment testing is done for cash generating unit
  - To which the asset belongs
- What is cash generating unit
  - The smallest unit that generates cashflows mainly independently of other cash generating units
- Recogntion of units is done the same as is done for internal management, that is, for decisions of acquiring, disposal, restructuring of units
  - The same basis for assessing economic viability as internally done
- Identification of cashflows of the unit
  - If the output of one unit is an input for other units, the first unit is still independent if the output can be sold externally
- Cash generating units should be consistently defined from period to period
- Needless to say, while estimating the recoverable amount of the unit, the values of those assets that are specifically valued is excluded

Impairment of goodwill

- If goodwill is being carried as an asset in books, impairment testing will have to be done for goodwill also
- Impairment of goodwill is done by allocating goodwill based on
  - Bottom up test
  - Top down test
- Bottom-up test implies allocating goodwill on a reasonable basis to the smallest cash generating unit, and other units
  - Thus, the carrying value of the cash unit+ allocated goodwill is established
  - Now, we compute the value in use of the asset, and test if the asset is impaired
- Top down test would mean we allocate goodwill to larger units – say, the industrial unit itself
- In case of impairment of a cash generating unit
  - Impairment loss will be first allocated to Goodwill
  - Then to other assets in cash generating unit
- Impairment losses for goodwill are usually not reversible, except external situations that caused loss of goodwill cease to exist

Allocation of corporate assets

- Corporate assets are administrative assets that do not generate cashflows independently
- The value of the corporate assets should be allocated to cash generating units
- The cash generating units should then be tested for impairment

Reversal of impairment losses

- An impairment loss recognised earlier may be reversed if there are indications that the asset is no longer impaired
  - Reversal of impairment does not mean revaluation of the asset
    - Revaluations are covered by AS 10
- External indicators
  - Assets market value has increased
  - Significant changes have occurred that favourably affect asset values
  - Market interest rates have come down – discounting rates are reduced
- Internal indicators
  - Significant favourable changes have taken place internally indicating the asset may be in good use
  - Internal evidence indicates that the asset may perform better than expected
- While estimating the reversal of the impairment, care should be taken not to reverse impairment merely because cashflows are being discounted for shorter periods
  - Timing effect of the cashflows

Impairment in case of discontinuation of operations

- In case of announcement of a plan for discontinuation of operations, there is a case for testing the assets for impairment
- The recoverable amount for the assets to be disposed of/discontinued on block basis are estimated
  - Allocated to different units, if different units are expected to generate cashflows independently
  - Or else treated on block basis
- If assets are disposed of on piecemeal basis, values taken as such

Disclosures

- Amount of impairment loss recognised in P/L
- Reversal of impairment recognised in P/L
- Impairment loss taken directly to revaluation reserves
- Reversal of impairment taken to revaluation
- In case of significant impairment/reversal, enterprise should disclose
  - Events and circumstances leading to impairment
  - Amount of impairment loss
  - Individual assets – nature of the asset
  - Cash generating units – description of the cash generating unit
  - Whether recoverable amount is net selling price or value in use
  - If value in use, the discounting rate used