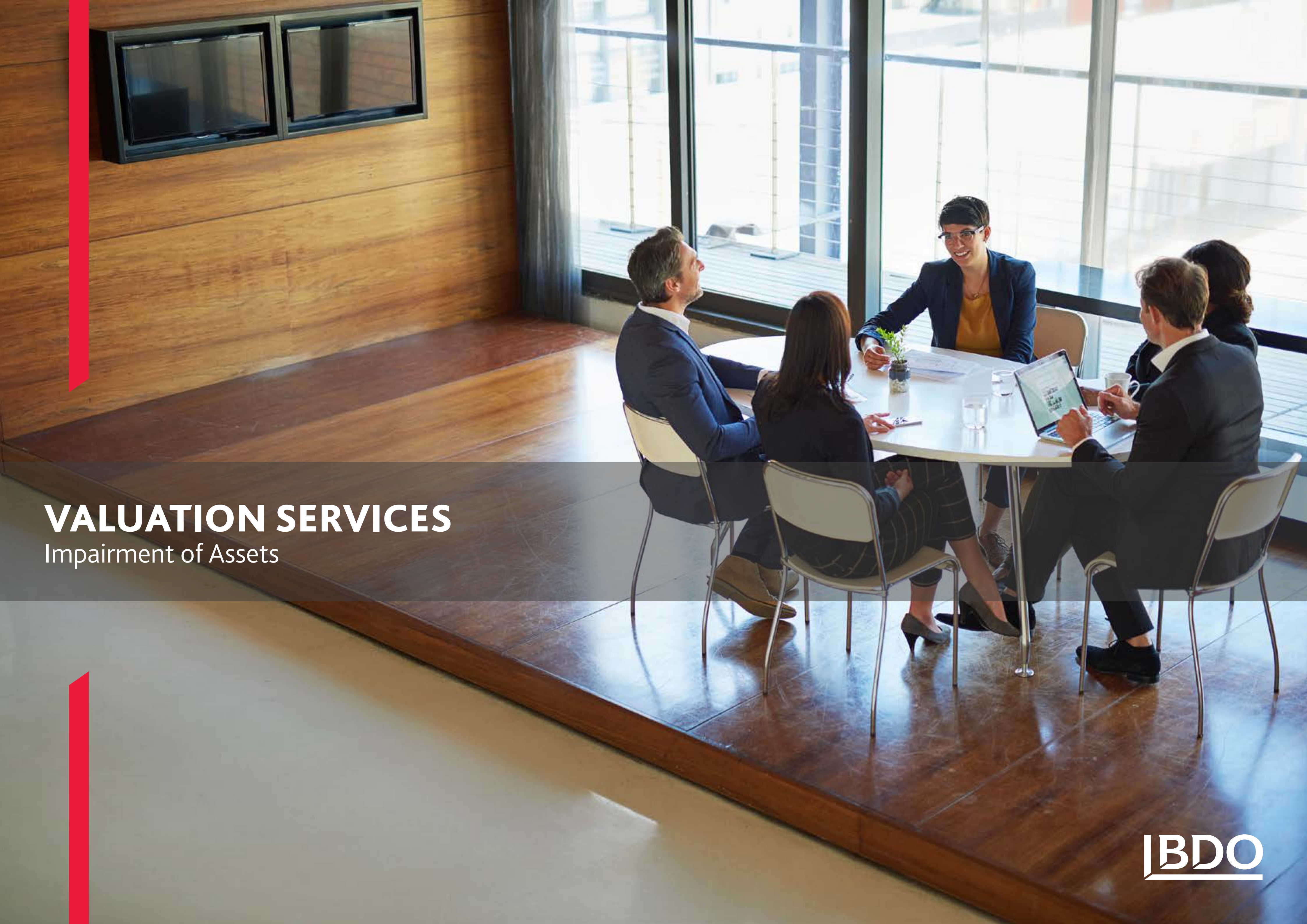

VALUATION SERVICES

Impairment of Assets

VALUATION SERVICES
IMPAIRMENT OF ASSETS

Asset impairment attracts significant scrutiny from equity markets, the media and regulators.

Impairment testing refers to the process of comparing the recoverable amount of the asset with its carrying amount.

In light of the current litigious environment, company directors are increasingly turning to third parties for independent impairment testing to assist with reducing their risk.

This guide provides an overview of the potential valuation issues related to impairment testing, information on how you can avoid some common valuation errors in the impairment context and tips for simplifying the impairment process for your organisation.

WHAT IS INVOLVED?

Australian Accounting Standards AASB 136 *Impairment of Assets* sets out the requirements for impairment testing of certain non-financial assets.

AASB 136 requires an asset's carrying or book value to be compared to its recoverable amount. This involves a number of steps which require a detailed understanding of the application of AASB 136 and valuation theory in the context of your company.

The impairment testing process is summarised below:

When are assets required to be tested for impairment?	• Annually – goodwill, indefinite life intangible assets and intangible assets not yet available for use • When there are indicators of impairment present – certain other non-financial assets
How is an asset tested for impairment?	• Assets are grouped at the lowest level possible to independently generate cash flows. This group of assets is referred to as a 'cash generating unit' or 'CGU'. For some assets, the individual asset itself will form a CGU. • Estimate the recoverable amount of the CGU • Compare the recoverable amount of the CGU with its carrying amount
What results from impairment testing?	• If the carrying amount is greater than the recoverable amount, the CGU is impaired • In this situation, AASB 136 requires that the CGU be written down to its recoverable amount.

CALCULATING THE RECOVERABLE AMOUNT

KEY CONCEPTS

Below we briefly explain some of the key concepts involved in impairment testing:

Key Concept	Description
Indicator of Impairment	Refers to any pre-identified triggers which may suggest the existence of impairment. Considerations include: • external sources of information, e.g. changes in the technical, legal or market environment that may have an adverse effect on the CGU. • internal sources of information, e.g. evidence of physical damage, obsolescence or a change in the manner in which a CGU is expected to be used. An example of an external indicator may be where the carrying amount of an asset exceeds the company's market capitalisation. An example of an internal indicator may be where actual monthly performance is significantly lower than budgeted performance.
Cash Generating Unit (CGU)	Refers to the smallest group of identifiable assets that generates cash inflow independently of the cash flows generated by other assets.
Recoverable Amount	The higher of an asset's or CGU's: • Fair Value less Costs of Disposal (FVLCD); • Value in Use (VIU). VIU is based on the estimated future cash inflows and outflows from the use and ultimate disposal of the asset (where applicable), discounted at an appropriate rate. FVLCD is based on fair value of the asset or CGU, as determined using market evidence where available, less costs directly attributable to disposal of the asset. E.g.: Specialised machinery may have minimal value in the market on a stand-alone basis but may contribute significantly through its use as part of a production system for particular business. In this example, the VIU may exceed FVLCD and reflect the recoverable amount of the asset for impairment testing purposes.

Companies may be required to calculate the recoverable amount of an asset or each CGU.

Recoverable amount **= Higher of**
- Value in use
- Fair value less cost of disposal

It is not essential for a company to calculate both the VIU and FVLCD for comparison with the CGU's carrying amount. A company may calculate either or both values, depending on their relevance.

FVLCD	VIU
The existence of market participants	Forecast cash flows are required to be determined for market participants.
The disposal must be assumed to be carried out in an orderly manner and the costs of disposal must be deducted from the estimated fair value	A relevant discount rate must be estimated and the valuation is to be completed on a discounted cash flow basis
	The cash flows must reflect the asset or CGU in its current condition

OUTCOMES OF IMPAIRMENT TESTING

Impairment testing results in a binary outcome. The recoverable amount of the CGU is either:

- **Lower than its carrying amount,** in which case
  – the Individual asset/CGU is required to be written down (impaired) to its recoverable amount; or
- **Higher than its carrying amount ,** in which case
  – the carrying amount remains unchanged and no impairment loss is recognised. Any previous impairment recorded may also be reversed in certain cases.

Impairment losses may result from temporary fluctuations in variables such as commodity prices. Only impairment of goodwill cannot be reversed in future accounting periods. Impairment of other assets may be reversed in instances where there has been a change in the estimates used to determine the asset's recoverable amount. Any reversal of impairment cannot result in the asset's carrying amount exceeding the carrying amount that would have been determined (net of depreciation and amortisation), had no impairment loss previously been recognised.

SOME COMMON ERRORS AND HOW TO AVOID THEM

There are a number of valuation issues including those ASIC has identified in their surveillance1 in relation to impairment. The following is a summary of some of those issues and an indication of possible actions which a company could undertake to mitigate those issues:

Issues	Possible action
Adopting an unrealistic, value as recoverable amount	• Calculate recoverable amount (VIU or FVLCD) in accordance with the requirements of AASB 136 • Engage an independent adviser to undertake or review the valuation calculations completed by the company.
CGUs identified at too high a level	• Identify CGUs at the lowest level that management assesses operations.
Forecasting inappropriate cash flows (no regard to historical results, business and economic cyclicality or funding)	• Ensure cash flow assumptions are reasonable and supportable • Support the forecasts relative to historical performance with as much independent data as is reasonably available • Ensure cash flows are prepared on a pre-tax basis.
Applying an unsuitable discount rate, which does not reflect the level of risk for the type of CGU	• Establish the discount rate from first principles • Compare the discount rate to similar businesses • Eansure pre-tax discount rate is applied.
Material enhancements incorporated over the forecast period	• When valuing an individual asset or CGUs using the VIU method, AASB 136 requires that the recoverable amount be calculated based on the current service potential of the asset and any expansions, enhancements or material upgrades should not be included in the forecast calculations.
Failing to undertake a cross-check to interrogate the reasonableness of the recoverable amount calculation	• Incorporate at least one relevant cross-check to establish reasonableness of the calculated value.

1. *http://asic.gov.au/regulatory-resources/financial-reporting-and-audit/directors-and-financial-reporting/impairment-of-non-financial-assets-materials-for-directors/#common-issues*

YOUR IMPAIRMENT TESTING CHECKLIST

In many cases, impairment testing can be considered prior to financial year end, and indicators of impairment are to be considered throughout the year.

As part of impairment testing, consider the following:

- Review and identify all impairment indicators
- Complete the annual impairment test for indefinite life intangibles and goodwill, intangibles not available for use and tangible assets for which there is an indicator of impairment
- Establish and identify cash generating units
- Appropriately calculate the recoverable amount and appropriately explain its basis:
  - Fair value less costs of disposal
  - Value in use
- Conduct sensitivity analysis for key variables
- Conduct an appropriate cross check

At year-end, it is important to check whether any indicators of impairment have been triggered, particularly relating to any unexpected changes in market conditions.

HOW BDO CAN HELP

We offer comprehensive impairment testing services which enable our clients to meet compliance requirements in an efficient and cost effective manner.

We can assist you by providing detailed impairment testing services or by reviewing your internally prepared impairment assessment. Our impairment testing services generally include preparing a detailed, robust and auditable financial model, a report which sets out the assumptions, calculations and conclusions as well as a pro forma disclosure note which may be utilised in your financial statements.

We offer a unique value proposition when it comes to impairment assessment including:

- Partner led delivery and senior experienced personnel
- Real commercial acumen enabling an understanding of the issues and stakeholders involved and the importance of providing high quality advice specific to your business
- Extensive experience in impairment testing
- Project based management which ensures that key personnel are always available for your project
- Competitive rates.

We have assisted a significant number of listed and unlisted Australian and international companies with impairment testing. Our extensive experience includes:

- Preparing position papers to support adopted values
- Assist with the financial modelling for CGUs
- Interrogating the reasonableness of cash flows
- Calculating discount rates for specific assets, companies or projects
- Conducting calculations and providing accounting advice in accordance with the relevant standards.

OUR RECENT EXPERIENCE

We have a team of approximately 20 dedicated Corporate Finance professionals in Brisbane. We have extensive experience in providing impairment testing services including detailed financial modelling and accounting advice to our private and public sector clients. Our recent experience includes:

Council owned airport operator BDO completed impairment testing of an airport CGU using DCF methodology to calculate value in use and fair value less cost of disposal. We cross-checked the impairment testing calculation using observed trading and transaction multiples.	**Coal mining company** BDO completed impairment testing of the coal mining assets in accordance with both Australian and United States Accounting Standards. Completion of the US impairment testing required additional cross-checks
Government owned port authority BDO provided financial modelling assistance for impairment testing purposes. We assisted the client with improvements in model functionality to enable multi-period reporting and incorporated a number of reconciliations and calculations to ensure compliance with AASB 136.	**Unlisted pharmacy retailer** BDO completed a review of the impairment model including a consideration of key assumptions such as the discount rate and the calculation of terminal value.

NEED HELP?

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