The impairment of non-financial assets

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Aim

» The aim of this session is to provide an understanding of accounting for the impairment of non-financial assets in accordance with IFRS Accounting Standards in the Ethiopian context.

» *Note 1: in Monday's session we explored the subclassification of non-financial assets; and*

» *Note 2: in Tuesday's session we explored the IFRS accounting models for non-financial assets.*

Overview

» Which non-financial asset impairment test?

» When to test non-financial assets for impairment?

» What to test for impairment (unit of account)?

» How to measure:

  » **net realisable value** of inventories?

  » **recoverable amount**: value in use and fair value less costs to sell?

» Examples

Aims

This session is designed to enhance your understanding of:

» when to test particular assets for impairment

» the unit of account for particular impairment tests
  - » item-by-item
  - » cash-generating units
  - » corporate assets
  - » goodwill

» the measurement of impairment losses
  - » value in use
  - » fair value less costs to sell
  - » net realisable value

Many measurements for assets

Impairment 'concept': the carrying amount of an asset should not be greater than the entity expects to recover from its sale or use

	IFRS	Impairment necessary?
Historical cost	√	√
Modified historical cost	√	√
Fair value	√	✗
Fair value less costs to sell	√	✗
Value in use	√	an impairment measurement
Net realisable value	√	an impairment measurement
Other measurements	√	√

Which impairment test applies to which assets

Which impairment test?
Summary of class discussion

Measurement model	Which impairment test?
Cost model (PPE, intangibles and investment property)	✓ Recoverable amount
FVPL model (sometimes called 'mark-to-market')	✗
FV less costs to sell model (Agriculture)	✗
Revaluation model (PPE and some intangibles)	✓ Recoverable amount
Net realisable value model (some inventories)	✗
Lower of cost and NRV (many inventories)	✓ Net realisable value
Lower of reclassification carrying amount and FVLCTS (many IFRS 5)	✓ Fair value less costs to sell

Recoverable amount impairment measurement
Which assets?
Summary of class discussion

Asset	IAS 36
Property, plant and equipment: cost model and revaluation model	✓
Intangible assets: cost model and revaluation model	✓
Exploration for and evaluation of mineral resources	✓
Investment property: cost model only	✓
Investments in associates and joint ventures accounted for using the equity method	✓

10

Other impairment measurement
which measure / which assets?
Summary of class discussion

Net realisable value (NRV)	IFRS
Inventories	✓IAS 2

Fair value less costs of disposal	IFRS
Non-current assets held for sale	✓ IFRS 5

11

When to test non-financial assets for impairment

When to test for impairment

- Inventory (IAS 2)
  - at the end of each reporting period
- Other non-financial assets (IAS 36)
  - at reporting date assess whether there is any indication that an asset may be impaired
  - if any such indication exists perform impairment test
- Irrespective of whether there is any indication of impairment: (paragraph 10 of IAS 36) test for impairment:
  - at the same time each year (and whenever impairment is indicated) goodwill, indefinite life intangible asset or an intangible asset not yet available for use; and
  - such assets must be tested for impairment in the year of their acquisition.

IAS 36 *Impairment of Assets*
impairment indicators

Consider, as a minimum: external and internal sources of information

» External sources of information

» asset's market value declined significantly > expected

» significant changes in the technological, market, economic or legal environment

» market rates increased (for example, effect on discount rate)

» carrying amount of the net assets > estimated fair value of the entity

IAS 36 *Impairment of Assets*
impairment indicators

» Internal sources of information

» obsolete or physical damaged asset

» significant changes in the extent or manner in which, an asset is (or is expected to be) used

» for example, idle assets, plans to discontinue or restructure operation, plans to dispose before expected, and reassessing the useful life from indefinite to finite

» internal reporting indicates that the economic performance of an asset is, or will be, worse than expected

IFRS 6 *Exploration for and Evaluation of Mineral Resources* *impairment indicators*

» Impairment indicators (paragraph 20 of IFRS 6)

(a) the period for which the entity has the right to explore in the specific area has expired during the period or will expire in the near future, and is not expected to be renewed.

(b) substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned.

(c) exploration for and evaluation of mineral resources in the specific area have not led to the discovery of commercially viable quantities of mineral resources and the entity has decided to discontinue such activities in the specific area.

(d) sufficient data exist to indicate that, although a development in the specific area is likely to proceed, the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale.

16

16

What to test for impairment (unit of account)

17

Impairment testing level
IAS 2 Inventories

Inventories

- Principle: test inventory for impairment item by item
- Exception (a rule): impairment test a group of items when:
  - it is impracticable to determine net realisable value (NRV) item by item; and
  - the inventories relate to the same product line and have similar purposes or end uses and are produced and marketed in the same geographical area

Impairment testing level
IAS 36 PPE, intangibles, investment property etc

Other non-financial assets

- Principle—test for impairment at the individual asset level (ie item-by-item)
- Application guidance is necessary for cash-generating units and corporate assets
- An exception from the principle (a rule) is permitted for goodwill

Impairment testing level
IAS 36 cash-generating units

- Test individual assets for impairment
- However, if impossible to estimate the recoverable amount of an individual asset then determine the recoverable amount of the cash-generating unit (CGU) to which it relates
  - CGU is the the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Better disclosures about CGUs
Example 1 identified by FRC (UK) (emphasis added)

"Cash generating units are deemed to be individual units or a cluster of units depending on the nature of the trading environment in which they operate. We only consider sites as a cluster of units, i.e. as a single CGU, where they are in a single, shared location, such as an airport, such that demand at one unit can directly affect that of other units in the same location." (The Restaurant Group plc Annual Report 2018)

The registrant "explained how individual CGUs had been grouped for the purposes of allocating goodwill or intangible assets" (FRC (UK))

Source: FRC (UK), Thematic Review: Impairment of Non-financial Assets (2019), p8

Better disclosures about CGUs
Example 2 identified by FRC (UK) (emphasis added)

"The Group had four cash generating units at the beginning of the year… During the year it was recognised that the cash inflows of the Nationals and Regionals cash generating units were largely interdependent such that they have been combined into a single cash generating unit. The increase in the interdependency has been accelerated due to the increased scale of advertising packages sold across all titles and websites and reflects the group wide nature of our wholesale and distribution contracts" (Reach plc Annual Report 2018)

The registrant "described how CGUs were identified, and whether that had changed from the prior period" (FRC (UK))

Source: FRC (UK), Thematic Review: Impairment of Non-financial Assets (2019), p8

Impairment testing level
IAS 36 corporate assets

» Principle: test for impairment at the individual asset level

» Application guidance for corporate assets: Because corporate assets do not generate separate cash inflows, the recoverable amount of an individual corporate asset cannot be determined unless management has decided to dispose of the asset.

  » As a consequence, if there is an indication that a corporate asset may be impaired, recoverable amount is determined for the cash-generating unit or group of cash-generating units to which the corporate asset belongs, and is compared with the carrying amount of this cash-generating unit or group of cash-generating units. (paragraph 101 of IAS 36)

Impairment testing level
IAS 36 goodwill

» Goodwill is tested for impairment at the lowest level at which it is monitored for internal management (ie CODM) purposes provided that level is not larger than an operating segment as defined in IFRS 8 (before aggregation) (paragraph 80 of IAS 36)

» Why does IFRS permit this exception from the CGU principle for the impairment testing of goodwill?

Impairment testing level
IAS 36 (goodwill)

"An operating segment is a component of an entity:

(a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);

(b) whose operating results are regularly reviewed by the entity's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance; and

(c) for which discrete financial information is available."

(paragraph 5 of IFRS 8 *Operating Segments*)

Net realisable value (expected selling price less costs to complete and sell)

26

Net realisable value 'concept'
source: IAS 2 Inventories

- The net realisable value of an asset is the amount that the entity can currently obtain from the sale of the asset in an orderly transaction, after deducting the costs (to complete) and sell.
- In other words, net realisable value is:
  - expected selling price; less
  - expected costs to complete; less
  - expected costs to sell.
- Note: when cash flows from future use are immaterial, net realisable value = value in use.

27

Net realisable value: raw material inventory
Summary of class discussion

Example 1:

At 31 December 2017

» carrying amount (cost) of raw materials = ETB2,000,000
» replacement cost = ETB1,500,000
» fair value = ETB1,250,000; cost to sell raw material would = ETB50,000
» expected selling price of finished good = ETB3,000,000
» expected cost to convert the raw material into finished good = ETB1,200,000
» expected costs to sell the finished good = ETB200,000

The net realisable value of the raw material is? Choose one of:

1) ETB2,000,000; 2) ETB1,500,000; 3) ETB1,250,000; 4) ETB1,200,000; 5) ETB1,800,000; or 6) ETB1,600,000.

Net realisable value: finished goods inventory
Summary of class discussion

Example 2:

At 31 December 2017 Entity has 3 items of finished goods:

» Item A cost = ETB90; Item B cost = ETB100; Item C cost = ETB110
» If sold as a group of 3 items, NRV = ETB300
» If sold individually, NRV = ETB100 per item

Must Entity recognise an impairment loss in 2017? Choose one of:

1) Yes: ETB10 impairment expense for Item A;
2) No: cost of group of items = ETB300 and NRV = ETB300; or
3) It depends on whether the inventory satisfies the criteria for testing for impairment as a group of items.

Net realisable value: finished goods inventory
Summary of class discussion

Example 3:

At 31 December 2017 Entity has 1,000 homogenous perishable items of finished goods that each cost ETB10 to manufacture.

» On the basis of its experience the Entity expects to sell only 250 of the items before they pass their 'sell by date'.

» The expected selling price of each item is ETB105 and costs of disposal are expected to be ETB5 per item.

Must Entity recognise an impairment loss in 2017? Choose one of:

1) Yes: ETB7,500 impairment expense (750 items x ETB10 cost each);
2) No: cost of the group of items = ETB10,000 and NRV = ETB25,000; or
3) It depends on whether the inventory satisfies the criteria for testing for impairment as a group of items.

Net realisable value
judgements and estimates

» Measuring net realisable value involves estimating the entity specific:
- » selling price;
- » costs to complete; and
- » costs to sell

» Judgement is applied in:
- » identifying impaired inventories
- » identifying when the circumstances that caused the impairment no longer exist or when there is clear evidence that NRV has increased due to changed economic circumstances (for the purpose of reversing prior period impairments)
- » determining whether it is impracticable to determine NRV item-by-item; and if so, judging whether they qualify for impairment testing as a group (ie inventories relate to the same product line and have similar purposes or end uses and are produced and marketed in the same geographical area)

Recoverable amount

Recoverable amount
how it is measured and what is done with it

- The recoverable amount of an asset is the greater of:
  - its fair value less costs to sell; and
  - its value in use.
- The carrying amount of an asset is reduced to its recoverable amount
  - the 'write down' is an expense included in profit or loss unless a Standard requires differently
    - for example, reversals of prior period revaluations are presented in other comprehensive income (OCI)

Value in use

Value in use of an asset

- To measure value in use
  - estimate future cash flows (in and out) from <u>continuing use</u> of the asset
  - estimate future cash flows (in and out) from <u>ultimate disposal</u> of the asset
  - apply appropriate discount rate to future cash flows
- Cash flow estimates do not include cash flows from
  - <u>improving</u> or enhancing the asset's performance (measuring the existing asset not a possible future asset)
  - cash flows from <u>financing</u> activities (a separate liability)
  - <u>income tax</u> receipts and payments (a separate asset or liability)

Value in use asset
explanation: paragraph 6.35 of IASB ED /2015/3

» The value in use of an asset reflects the following factors using entity-specific assumptions:
  » estimates of future cash flows
  » variations in the estimated timing and amounts of future cash flows caused by uncertainties inherent in the cash flows
  » the time value of money
  » risks specific to the asset or liability (sometimes called risk premium)

Value in use of an asset
application guidance: IAS 36 Impairment of Assets

» Reflect in the calculation of value in use
  » expectations about possible variations in the amount or timing of the estimated future cash flows the entity expects
  » time value of money (current market risk-free rate of interest)
  » price for uncertainty inherent in the asset
  » other factors (for example, illiquidity) that market participants would adjust for

» Avoid double-counting effects in future cash flows and in the discount rate

IAS 36 *Impairment of Assets*
value in use (cash flows)

- When estimating FCFs:
  - use recent budgets/forecasts to est. cash flows
  - extrapolate beyond forecast period using steady or declining growth rate, unless another is justified
- Est. FCFs for asset in current condition
- Est. FCFs do not include in/outflows from:
  - a future restructuring to which an entity is not yet committed
  - improving or enhancing the asset's performance
  - financing activities
  - income tax

IAS 36 *Impairment of Assets*
value in use (cash flows)

- When estimating FCFs:
  - base cash flow projections **on reasonable and supportable assumptions** that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. **Greater weight shall be given to external evidence**.
    - For example, published prices should be used.
      - **spot prices for commodities** unless there is a forecast price available from a **published forward price curve** as at the impairment test date.

Characteristics of value in use

- is an entity-specific value
- is an exit value
- takes account of uncertain future events, taking account of all possible outcomes in an unbiased manner
- reflect changes in expected future cash flows, changes in interest rates and changes in the amount of risk or in its price
- requires judgement to measure
  - estimating future cash flows from use and disposal
  - determining discount rates/s

Value in use
judgements and estimates

- Identifying internal and external indicators of impairment
- Identifying cash-generating units (CGUs)
- Allocating assets (eg goodwill) to CGUs
- Measuring VIU:
  - estimate future cash flows (in and out) from continuing use of the asset and its ultimate disposal, and
  - determine appropriate discount rate to apply to future cash flows
  - etc

Mini-case study 1: discount rates
What do you think?

- JSE identified instances of overstatement of assets when the measurement provisions of IAS 36 were not correctly applied.
- What discount rate is used when discounting cash flows in measuring value in use?
- Does the same discount rate apply to all of an entity's CGUs?

Source: Combined findings of the JSE proactive monitoring of financial statements: Reviews done 2011 to 2019

45

Mini-case study 1: discount rates
Summary of class discussion

What discount rate is used when discounting cash flows in measuring value in use?

- The discount rate/s in measuring value in use is (IAS 36):
  - the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset (paragraph 56).
  - **pre-tax** rate/s that reflect(s) current market assessments of (paragraph 55): (a) the **time value of money**; and (b) the **risks specific to the asset** for which the future cash flow estimates have not been adjusted.
    - pre-tax discount rate will not always be the grossed up post-tax discount rate (paragraph BCZ85 of the basis for conclusions on IAS 36).

Source: Combined findings of the JSE proactive monitoring of financial statements: Reviews done 2011 to 2019

46

Mini-case study 1: discount rates (regulatory action)
Summary of class discussion

Does the same discount rate apply to all of an entity's CGUs?

» Detailed questions were asked by the JSE when the **discount rate used in the impairment calculation was the same across all business units** and where issuers used their **historic entity weighted average cost of capital** as the discount rate. Issuers should refer to paragraphs 55 to 57 of IAS 36 when determining the discount rate to apply. (Matter 9, 2013)

» Measurement issues were identified after the JSE raised concern that **the same discount rate was used for different cash-generating units** (Matter 7, 2015).

» Issuers should also be mindful of the fact that paragraphs 51 and 55 of IAS 36 require the use of pre-tax cash flows and discount rates when computing a recoverable amount based on value in use. IAS 36.BCZ85 explains that the pre-tax discount rate will not always be the grossed up post-tax discount rate. (Matter 5, 2016)

Source: Combined findings of the JSE proactive monitoring of financial statements: Reviews done 2011 to 2019

Fair value less costs to sell (recall yesterday morning's session)

Fair value of an asset
the concept

» The fair value of <u>an asset</u> is:

- » the price that would be received to sell an asset (exit price)
- » in an orderly transaction (not a forced sale)
- » between market participants (market-based view)
- » at the measurement date (current price) (see IFRS 13 *Fair Value Measurement*)

» Market participant perspective: consequently, the entity’s intention to hold an asset is <u>not relevant</u> when measuring fair value.

Fair value less costs to sell

» For impairment testing purposes, deduct from fair value costs of disposal

- » **costs of disposal:** incremental costs directly attributable the disposal of the asset or CGU
  - » **excluding** finance costs and income tax expense

Contrasting inputs to DCF models when measuring value in use and fair value (Level 3)

Contrasting value in use and fair value measurement objective, perspective, valuation model and inputs

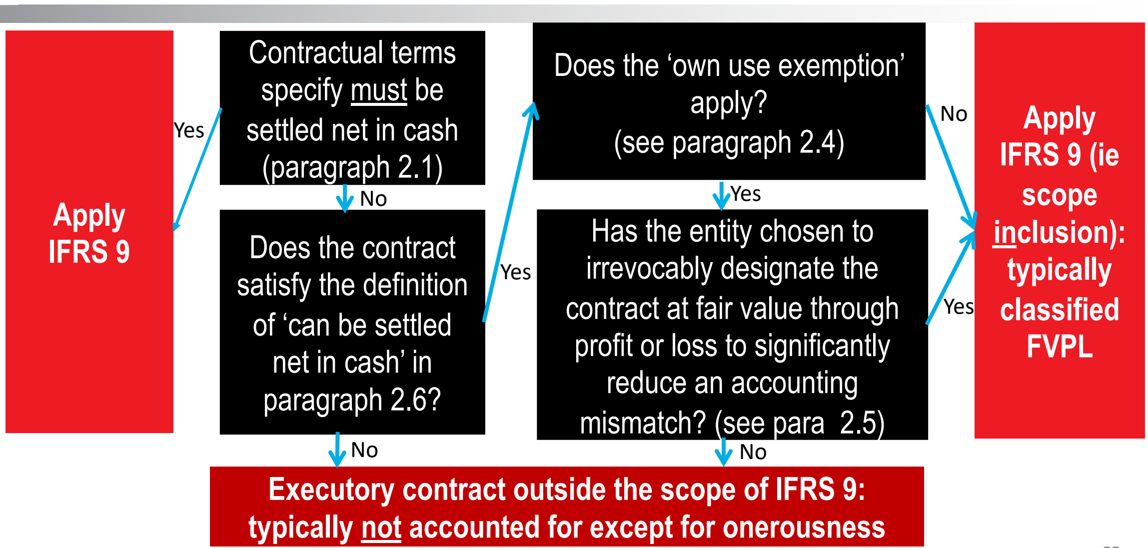
Summary of class discussion

	Value in Use	Fair Value
Measurement objective	Estimate PV of future net cash inflows	Estimate selling price in market
Measurement perspective	Entity-specific	Market participant
Assumed use of the asset	Current use	Highest and best use
Market conditions	Management's expectations (but constrained)	Market participant views of current market conditions
Valuation technique	Discounted cash flows	Whatever market participants use
Discount rate	'market based'	Market rates
Discrete projection period	5 years	Market participant expectations

Contrasting value in use and fair value measurement objective, perspective, valuation model and inputs
Summary of class discussion

	Value in Use	Fair Value
Future improving/enhancing asset's performance	Ignore	Market participant expectations
Possible future restructurings	Ignore	Market participant expectations
Growth rate	Usually average historical growth rates (but constrained)	Market participant expectations
Growth rate beyond discrete projection period	Steady or declining (unless convincing evidence)	Market participant expectations
Use of observable data	Reasonable and supportable assumptions	Maximise observable inputs the 'fair value hierarchy'
Tax assumption	Pre-tax: cash flows and discount rates	Silent (must be internally consistent)

IFRS 9 scope inclusion: non-financial item contract asset subject to impairment testing used in generating the commodity specified in the contract (ie the 'underlying')



Reference: paragraphs 2.1 and 2.4 to 2.6 of IFRS 9

Contrasting value in use and fair value ‘forward’ contracts: asset subject to impairment testing used in generating the commodity specified in the contract (ie the ‘underlying’)

The contract is…	Value in Use	Fair Value
…in the scope of IFRS 9 (see decision tree on previous slide)	Is the price in the contract relevant to measuring ViU?	Is the price in the contract relevant to measuring fair value?
…out the scope of IFRS 9 (see decision tree on previous slide) and ‘in the money’	Is the price in the contract relevant to measuring ViU?	Is the price in the contract relevant to measuring fair value?
…out the scope of IFRS 9 (see decision tree on previous slide) and ‘out of the money’	Is the price in the contract relevant to measuring ViU?	Is the price in the contract relevant to measuring fair value?

Contrasting value in use and fair value ‘forward’ contracts: asset subject to impairment testing used in generating the commodity specified in the contract (ie the ‘underlying’)

<table>
<tr><th>The contract is…</th><th>Value in Use</th><th>Fair Value</th></tr>
<tr><td>…in the scope of IFRS 9 (see decision tree on previous slide)</td><td>The contract is recognised as a separate asset/liability that is measured at its fair value. Consequently, the contract is irrelevant to calculating the VIU of the asset that produced it.</td><td rowspan="3">Irrespective of whether it is recognised separately, the value of the ‘fixed-price contract to sell the commodity’ is not necessarily relevant to measuring the fair value of the asset that produced it “because fair value reflects the current market conditions in which market participant buyer and sellers would enter into a transaction.” (paragraph 16 of IAS 41 Agriculture)
However, if entered into at the reporting date in an arm’s length transaction then the price specified in the contract could inform the input ‘commodity price’ for the coterminous delivery date.</td></tr>
<tr><td>…out the scope of IFRS 9 (see decision tree on previous slide) and ‘in the money’</td><td>The contract is relevant to calculating VIU of the asset that produced it only to the extent that the contract: (i) has not been recognised as a separate asset; <u>and</u> (ii) is not used to ‘protect’ another asset from impairment (eg inventory).</td></tr>
<tr><td>…out the scope of IFRS 9 (see decision tree on previous slide) and ‘out of the money’</td><td>The contract is relevant to calculating VIU of the asset that produced it only to the extent that the contract’: (i) has not been recognised as a separate liability (eg when the contract is onerous); and (ii) is not taken account of in measuring the impairment of another asset (eg, inventory).</td></tr>
</table>

Examples

75

Impairment of a cash-generating unit (and subsequent reversal)

81

Cash generating unit (CGU) impairment
the application guidance

» Allocate impairment loss:
- » **1st** to any goodwill allocated to the cash-generating unit (CGU)
- » **2nd** to other assets pro rata on the basis carrying amount of each asset in CGU
- » However, cannot reduce the carrying amount of any asset below the highest of nil, fair value less costs to sell and value in use (if determinable)
  - » reallocate any access impairment to other assets of the CGU

82

Cash generating unit (CGU) impairment
example cost model
What do you think?

At 31/12/2021 a fish harvesting CGU's assets:

» **carrying amount** = ETB2,300,000
- » ETB1,500,000 fishing boat
- » ETB500,000 fishing licence
- » ETB300,000 goodwill

» **recoverable amount** = ETB1,600,000 (value in use)
- » **fair value** of fishing boat = ETB1,400,000

83

Cash generating unit (CGU) impairment
example cost model
Summary of class discussion

- CGU's asset impairment loss (an expense) = ETB700,000
  - ie ETB2,300,000 carrying amount less ETB1,600,000 recoverable amount
- Allocate ETB700,000 impairment loss to CGU's assets, as follows:
  - **1st** allocate ETB300,000 loss to goodwill
  - **2nd** allocate remaining ETB400,000 loss: ETB300,000 to the boat and ETB100,000 to the licence (pro rata on carrying amount)
  - **3rd** reallocate ETB200,000 loss from boat to licence
- After impairment the carrying amount of the CGU's assets are:
  - nil goodwill, ETB1,400,000 boat and ETB200,000 licence

CGU reversal of prior period impairment
example cost model extended
What do you think?

At 31/12/2022 the fish harvesting CGU's assets:

- **carrying amount** = ETB1,200,000
  - ETB1,050,000 fishing boat + ETB150,000 fishing licence + nil goodwill
- **recoverable amount** = ETB1,800,000 (value in use)
  - fair value of fishing boat = ETB1,250,000
- hypothetical carrying amount if no impairment in 2021 = ETB1,725,000
  - ie ETB1,125,000 fishing boat + ETB375,000 fishing licence + ETB225,000 goodwill
- maximum potential impairment loss reversal (income) = ETB600,000
  - ie ETB1,800,000 recoverable amount less ETB1,200,000 carrying amount

CGU reversal of prior period impairment
example cost model extended
Summary of class discussion

Allocate reversal of impairment loss to CGU's assets, as follows:

» nil to goodwill because cannot recognise (new) internally generated goodwill.

» ETB525,000 to the boat and ETB75,000 to the licence (pro rata on carrying amount)

  » BUT limit gain on boat and licence to ETB75,000 and ETB225,000 respectively because cannot exceed what carrying amount would be had the 2021 impairment not occurred

  » BECAUSE there are no other assets in the CGU to 'absorb' the unallocated potential prior period impairment reversal, the gain (income) from the reversal of the prior period impairment is **limited to ETB300,000 in 2022**

    » **ETB75,000 fishing boat + ETB225,000 fishing licence**

Thank you for actively participating in the session!