IAS 36- Impairment of Assets

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The current Covid-19 crisis and the resulting economic downturn in Egypt and around the globe are unprecedented and have a significant effect on businesses globally including your business. Significant adverse changes in the business climate is an indicator of impairment by itself. As a result, under current conditions it is more likely than not that most entities must carry out detailed impairment tests.

Since impairment testing is an area in which significant judgment is required, our top tips to get through this based on our experience are:

1– Start immediately:

Do not underestimate how long the impairment testing process takes. It includes identifying impairment indicators, assessing or reassessing the cash flows, determining the discount rates, testing the reasonableness of the assumptions and benchmarking the assumptions with the market.

The process should be begun early. It is not an exercise that can be safely left to the last minute. Our experience in FINSIGHTS Consulting is that this can take anywhere from 3-5 weeks.

2. Comply with disclosure requirements

IAS 36 'Impairment of Assets' and IAS 1, 'Presentation of financial statements', have many disclosure requirements. The disclosure requirements are extensive. Common omitted disclosures we have seen include the discount rates applied, the long-term growth rate assumptions in a discounted cash flow model for both value in use and fair value less cost to sell, and a description of the key assumptions made and what these have been based on. Key assumptions are those to which the recoverable amount is most sensitive; for example, assumptions on revenue growth, profit margins and discount rates. Additional sensitivity disclosures are required for significant goodwill or indefinite-lived intangible asset balances if a reasonably possible change in a key assumption causes the carrying amount to exceed the recoverable amount. Given the current volatile markets, management should pay extra attention to sensitivity analysis, this is an area that requires considerable thought.

3. Scrutinize the discount rate

The discount rate used in determining value in use, which reflects current market assessments of the time value of money and the risks specific to the asset or cash generating unit (CGU), is based on 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 of the asset or CGU. In other words, the discount rate is based on a market participant's view of the asset or CGU as at the current date. Therefore, while the cash flows in the value in use calculation are entity-specific, the discount rate is not.

Therefore, there is a need to reassess discount rates compared to those used in previous periods. However, the weighted average cost of capital (WACC) is a complex calculation and comprises a number of elements, each of which should be analyzed carefully. Some of these elements may be based on long-term measures that may not have changed markedly despite recent market volatility. This latter observation applies particularly to beta factors and equity risk premium that form part of the cost of equity; when this is the case, particular attention should be paid to the alpha factor component of the cost of equity, e.g., the forecasting risk component, to ensure that the overall cost of equity component of WACC is representative of the premium that would be required by market participants at the measurement date.

The cost of debt should be based on long-term rates being incurred at present for new borrowings, rather than the rates negotiated historically in the debt market for existing borrowings. The determination of appropriate rates includes consideration of recent refinancing transactions, which, in the current environment, might be at rates considerably higher than the original financing. The gearing and the cost of debt used in the WACC calculation are not entity-specific; IAS 36 notes that the discount rate should be independent of the entity's capital structure and the way in which the entity financed the acquisition of the asset (or CGU) [IAS 36.A19]. Therefore, the gearing and the cost of debt should be market-driven (The actual funding of the CGU, which often will include intra-group debt, is not relevant in determining gearing for the purposes of the market participant's WACC).

It should be noted that a key assumption underpinning WACC is a constant level of gearing throughout the cash flow period, including in the terminal value. If this assumption does not apply, then it will be necessary to calculate WACC separately each year using different gearing levels as applicable.

The discount rate should not be adjusted for risks that have already been considered in projecting future cash flows. In most cases, however, discounted cash flow calculations based on approved budgets will not have been risk-adjusted, so the discount rate should not be reduced. Management should also consider country risk, currency risk and cash flow risk. Different rates should be used for different future periods with different risks where appropriate.

4. Value in use should comply with the standard

In calculating value in use, future cash flows should be estimated for assets in their current condition. Key constraints concerning the assumptions that can be made in value-in use- compliant cash flow forecasts relate to future restructuring or reorganizations and capital investment. The costs and benefits of a future restructuring should not be recognized in the cash flow forecasts, unless the entity is committed to the restructuring and the related provisions have been made. The costs and benefits of future expenditure that is intended to improve or enhance the assets or business should be excluded from the forecasted cash flows.

5. Cash flows in the impairment calculations should be reasonable and supportable

IAS 36 requires value in use to be determined using pre-tax cash flows and a pre-tax discount rate. However, in practice it is common to use post-tax cash flows and a post-tax discount rate, which is discussed in Insights 3.10.260.

Forecasts prepared months ago may need to be revised. Forecasts need to be based on the latest management-approved budgets or forecasts, but these should be based on reasonable and supportable assumptions that represent management’s best estimate of the economic circumstances that will prevail over the remaining life of the asset or CGU. Greater weight should be given to external evidence.

Management's detailed forecasts should cover a period of up to five years. IAS 36 limits the detailed forecast period to five years unless management is confident that its forecasts are reliable, supported by experience of being able to forecast accurately. Cash flows after the forecast period are projected by applying a growth rate, usually steady or declining; these cash flows form the basis of what is referred to as the terminal value.

Also consider a multistage terminal value if you expect several stages beyond the explicit period in order to reflect the impact of economic contraction and a subsequent return to maintainable earnings.

Consider the relations between capital expenditures and growth rate, depreciation and capital expenditures, historical performance and future expectations, gearing and Beta and similar relations.

Please contact us if you have any inquiries, we are happy to provide more detailed insights on a case-by- case basis.

FINSIGHTS Consulting Team

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WHERE ?

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