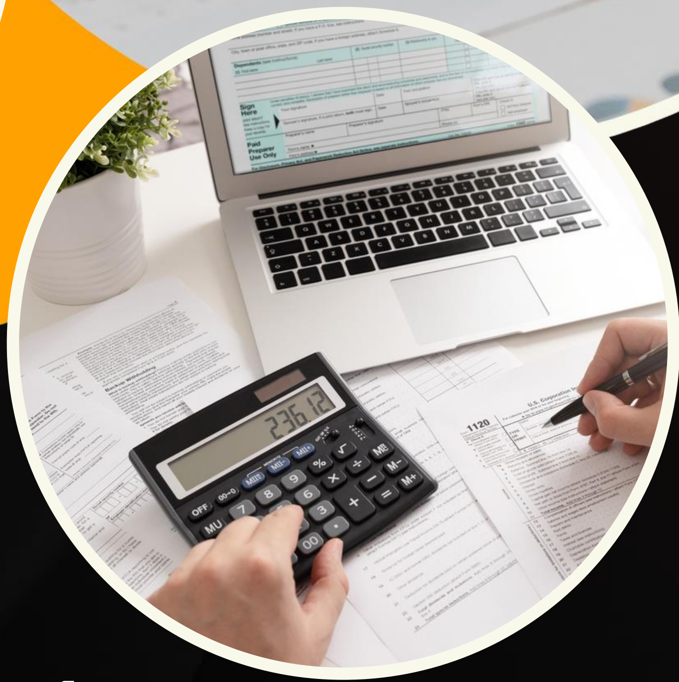
PARTNERS BEYOND BOUNDARIES



Impairment of Assets

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Guidance pertaining to impairment testing of goodwill and other indefinite lived intangible assets is covered under IAS 36 Impairment of Assets. The impairment testing process under the standard is based on a comparative approach wherein the carrying value of the asset is compared to its recoverable value. If the carrying value of the subject asset is higher than the recoverable value, the asset is said to be impaired, and an impairment loss is recognized.

Overall impairment testing

The accounting standard prescribes a single step impairment process for determining impairment loss. The premise of the test is to calculate the recoverable value of the asset, or the cash-generating unit and compare it with its carrying amount.

The recoverable value under IAS 36 is defined as higher of the value in use and fair value less costs of disposal. Fair value is defined as, “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Value in use is defined as, “the present value of the future cash flows expected to be derived from an asset or cash-generating unit.”

If the cash flows of a particular asset cannot be separately identified, then in accordance with IAS 36, the cash-generating unit to which asset belongs should be tested for impairment. A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets.

It is pertinent to note that it is not necessary to calculate both i.e., fair value less costs of disposal as well as the value in use, if either of the two exceeds the carrying value of the asset.

Computation of fair value less costs of disposal and value in use

Fair value under IAS 36 is determined in accordance with IFRS 13 - Fair Value Measurement. Per FRS 36, the best estimate of fair value less cost of disposals is a price in a binding sale agreement in an arm’s length transaction, adjusted for incremental costs directly attributable to the disposal of the asset. The standard also discuss the various alternative sources of information that could be referred for determination of fair value less costs of disposals such as:

- If the asset is traded in an active market, its market price less cost of disposal
- The amount that an entity could obtain from the disposal of the asset in an arm’s length transaction between knowledgeable, willing parties less costs of disposal

IAS 36 states that the best estimate of fair value is to examine the quoted price in an active market for an identical asset. However, the standard acknowledges that in some cases, it will not be possible to measure fair value less costs of disposal because there is no basis for making a reliable estimate of the price at which an orderly transaction to sell the asset would take place between market participants at the measurement date under current market conditions. In such cases, it prescribes that the entity may use the asset’s value in use as its recoverable amount.

For the purpose of calculation of value in use, the standards require that the following should be reflected in the calculation:

a) Estimate of the future cash flows expected to be derived from the asset
b) Expectations about possible variations in the amount or timing of cash flows
c) Time value of money
d) Price of bearing uncertainty inherent in the asset
e) Other factors such as illiquidity

IAS 36 specifically states that the cash flow projections used to compute the value in use must exclude any estimated inflows or outflows expected to arise from future restructurings or improvements/enhancements to the asset's performance. Thus, it requires cash flows to be based on the existing state of the asset.

Treatment of impairment loss under FRS 36

If the recoverable amount of the asset is less than the carrying amount, the difference is considered as impairment loss and the carrying amount of the asset is reduced by that amount. The corresponding treatment of the impairment loss is given in the profit or loss account. However, if the asset has been revalued in the past, the impairment loss shall first be set off against the revaluation reserve and the balance if any, shall be debited to the profit or loss account.

When a cash-generating unit has been tested for impairment, an impairment loss is recognized only when the carrying amount of the cash-generating unit exceeds its fair value. The loss is allocated to reduce the carrying amounts of the assets of the unit in the following order:

i. Reduce the carrying amount of any goodwill allocated to the cash-generating unit
ii. Allocate to other assets of the unit pro-rata on the basis of their carrying amounts.

Such reductions are treated akin to impairment of individual assets as discussed above.

IAS 38 Intangible Assets

Per IAS 38, entities have an option to perform a qualitative assessment test to determine whether the asset/goodwill is impaired. If after the assessment, the entity determines that it is more likely than not that the indefinite lived asset/goodwill is impaired, then the two-step process as discussed below is necessary.

IAS 38 prescribes the following process to test the intangible assets for impairment:

a) Calculate the fair value of the reporting unit and compare it with the carrying amount which includes goodwill.
b) In the event when the fair value is lower than the carrying amount of the reporting unit, the fair value is allocated to all the assets by performing a purchase price allocation and the implied value of the goodwill is recognized in the same way as it is recognized in a business combination. If the implied value of goodwill is lower than the carrying value, goodwill is said to be impaired, and the loss is to be recorded in the profit and loss account.

A reporting unit is defined as an operating segment or a level below operating segment. Operating segment is defined under IFRS 8 Operating Segments to have the following characteristics:

- The component engages in business activities from which it may earn revenues and incur expenses.
- The operating results of the component are regularly reviewed by the entity's chief operating decision maker.
- Discrete financial information about the component is available.

Computation of fair value of reporting unit

The fair value of the reporting unit per IAS 38 must be consistent with the definition of fair value per IFRS 13. Thus, all the underlying assumptions of fair value such as market participant assumptions need to be taken into consideration when determining fair value of the reporting unit in accordance with IAS 38.

Level of cash flows and discount rate

IAS 36 require the use of pre-tax discount rates for the purpose of the valuation analysis. However, owing to the practical application of the Capital Asset Pricing Model, the cost of equity derived is a post-tax cost. Thus, entities calculate the value in use or the fair value using a post-tax rate and post-tax cash flows. The pre-tax rate is then computed by applying an iterative process based on the understanding that the pre-tax cash flows at a pre-tax discount rate and the post-tax rate with the post-tax cash flows should result in the same value conclusion, provided the amount and the timings of future tax flows are taken into consideration.

IAS 38 does not provide any specific guidance relating to the level of cash flows and discount rates and states that there should be consistency in level of cash flows and the discount rate being used.

Allocation of assets and liabilities to the unit

When a reporting unit/cash-generating unit is being tested for impairment, it is important to determine which assets/liabilities should be included while determining the carrying value of the reporting unit/cash-generating unit. While such an ascertainment might be straight forward for certain assets, other assets may need further analysis for the same.

Under IAS 38, the assets acquired and liabilities assumed are allocated to a reporting unit as of acquisition date if following criteria are met:

- The assets or liabilities relate to the operations of a reporting unit.
- The assets or liabilities will be considered in determining the fair value of the reporting unit.

For the purpose of allocating assets and liabilities to the cash-generating unit, IAS 36 states that the cash-generating unit should be as follows:

a) Include the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use; and

b) Exclude the carrying amount of any recognized liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.

Allocation of goodwill to the unit

Goodwill recognized in a business combination under IFRS 3 Business Combinations, should be allocated among the reporting or cash-generating units. The allocation of goodwill is necessary in case if an impairment of goodwill is determined, and such loss is to be allocated to the cash-generating units in case of IAS 36 as or reporting units under IAS 38.

Goodwill that is acquired in a business combination shall be allocated as on the acquisition date to the units of the acquiring entity that are expected to benefit from the synergies of the combination even though the assets acquired and liabilities assumed may not be assigned to that unit.

Reversing an impairment loss

An impairment loss recognized in prior periods for an asset other than goodwill shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. A reversal of an impairment loss reflects an increase in the estimated service potential of an asset, either from use or from sale, since the date when an entity last recognized an impairment loss for that asset.

The increased carrying amount of said asset attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognized for the asset in prior years.

The corresponding treatment of the reversal is given in the profit or loss. However, if the asset has been revalued in the past, the reversal shall be treated as a revaluation increase.

Reversal of impairment loss	IAS 36	IAS 38
Goodwill	Prohibited	Prohibited
Other assets	Allowed	Prohibited

Impairment testing for property, plant and equipment

The process of recognizing and measuring an impairment loss under IAS 16 is a 3-step process as follows:

Step 1 - Indicators of impairment

A long-lived asset must be tested for impairment only when events or circumstances indicating that the carrying amount might not be recoverable exist. Examples of such indicators include significant decrease in market price of the asset, adverse change in legal factors or business climate affecting the value of the asset etc.

Step 2 - Test for recoverability

In case of presence of circumstances indicating impairment, the recoverability test is performed wherein the net undiscounted cash flows expected to be generated from the use of the long-lived asset and its eventual disposal. Cash flow estimation is based on the life of the long-lived asset or the primary asset in the group. Cash flows should also take into account the possible future outflows that are likely to occur during the life of the asset. The carrying amount of the asset/group of assets is then compared with the sum of undiscounted cash flows and if the former is higher, the asset is said to be impaired.

Step 3 - Measurement of impairment loss

If the undiscounted cash flows used in the recoverability test are less than the long-lived asset's (group's) carrying amount, an entity is required to determine the fair value of the long-lived asset (group) and recognize an impairment loss if the carrying amount of the long-lived asset (group) exceeds its fair value. The fair value for this purpose shall be determined based on principles consistent with IFRS 13 Fair Value Measurement.

Order of impairment testing

In certain situations, an indefinite-lived intangible asset, long-lived asset as well as goodwill of the reporting unit that comprises these assets need to be tested for impairment at the same time. The order of impairment testing is as follows:

i. Impairment testing of indefinite lived intangible asset

ii. Impairment testing of long-lived asset

iii. Goodwill impairment testing

Frequency of impairment testing

While long-lived assets need to be tested for impairment only when circumstances indicating impairment exist, goodwill or assets with an indefinite life should be tested on an annual basis. The annual impairment test for such assets can be performed at any time during the fiscal year provided the test is performed at the same time every year. The goodwill of a unit can be tested for impairment between the annual tests in case any event or circumstances indicate that it is more likely than not that an impairment exists.

Goodwill and other intangible assets may be tested between annual test dates if there is:

- A significant adverse change in legal factors or in the business climate
- An adverse action or assessment by a regulator
- Unanticipated competition
- A loss of key personnel
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of
- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a unit.

The importance of impairment testing cannot be undermined given the increasing number of companies having poor operating results and the increasing proportion of intangible assets as part of the entire assets owned by companies. Impairment testing is gradually but steadily graduating from being the exception to the rule.

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