

TREASURY ANALYSIS - INTERNATIONAL ACCOUNTING STANDARDS

AASB 136 Impairment of Assets (which in part replaces part of AASB 1010 Recoverable Amount and 1041 Revaluation of Non-Current Assets)

Major impacts of changes:

- AASB 136 applies to all assets, except those subject to another standard that has impairment provisions.
- It requires an entity to assess at each reporting date whether there is any indication that an asset (or cash-generating unit) may be impaired. If such indication exists, the entity must estimate the recoverable amount.
- In addition, goodwill and indefinite-life intangibles must be assessed annually for impairment.
- Detailed guidance is provided on -
 - indicators of impaired assets;
 - identifying cash-generating units;
 - how to measure value in use based on cash-flow projections.
- Future cash flows must be discounted to determine value in use.
- Management's estimates of future cash flows are used, not market participants' estimates as was required by AASB1041.

Key features of standard

Scope

- This standard addresses the recognition, measurement and impairment of assets. It largely replicates the recoverable amount test in AASB1010/ AASB1041.
- However, its scope is wider. It applies to all assets (current, non-current, at cost or revalued), except those subject to another standard that has impairment provisions eg inventories, financial assets covered by AASB 139 *Financial Instruments*, investment properties valued at fair value & non-current assets held for sale, etc (para 2).

Identifying Impaired Assets

- AASB 136 requires an entity to assess at each reporting date whether there is any indication that an asset (or cash-generating unit) may be impaired (or that an impairment has reversed) (para 95). It lists a minimum of external and internal indicators that must be considered (para 12).
 - External indicators of impairment:
 - an asset's market value has declined significantly more than expected;
 - adverse events in the technological, market, economic or legal environment;
 - market interest rate increases that are likely to affect an asset's value in use;
 - net assets of the entity exceed its market capitalisation.
 - Internal indicators of impairment:
 - obsolescence or physical damage of an asset;
 - adverse changes in the expected use of an asset, including plans for restructuring;
 - the performance of an asset will be less than expected.
- If (but only if) any such indication exists, an entity must estimate the recoverable amount of the asset (para 9).
- An entity must also assess at each reporting date (in addition to the above general requirements):
 - whether intangible assets with an indefinite life are impaired (para 10).
 - whether goodwill in a business combination is impaired (para 10).

Measuring Recoverable Amount

- An *impairment loss* is the amount by which the carrying amount of an asset exceeds its recoverable amount.
- *Recoverable amount* is defined as the higher of an asset's (or cash-generating unit's) fair value less costs to sell *and* value in use (para 6). Recoverable amount is determined for an individual asset, unless the cash flows generated by the asset is not largely independent, in which case it is determined for the cash generating unit to which the asset belongs.
- *Fair value* has the same definition as in AASB116.
- *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 (para 6). However the *value in use of assets of not-for profit entities that are not part of a cash-generating unit* is defined as depreciated replacement cost. This effectively exempts such assets from impairment testing.
- *Elements in calculating value in use* include:
 - the expected cash-flows; &
 - possible variations in cash flows*;
 - the risk-free rate;
 - the risks specific to the asset*;
 - other factors that market participants would include* (para 30-2 & para 55).

* The asterisked items can be reflected either as adjustments to future cash flows or adjustments to the discount rate (para 32).
- AASB 136 specifies that *the discount rate to be used* must be a pre-tax rate that takes into account the time value of money and the risks specific to the asset (para 55), and applies to cash flows from operations (para 50).
- An entity may *estimate the discount rate taking into account*:
 - the entity's weighted cost of capital (the Capital Asset Pricing Model);
 - the entity's incremental borrowing rate; and
 - other market borrowing rates (para 56-7 and the Appendix (paras A15-A21)).

The Appendix (which is part of the standard) describes how to use present value techniques to measure value in use.
- *Estimates of future cash flows* must be based on (para 33):
 - management's best estimates of the range of economic conditions that will exist over the remaining useful life of the asset (giving greater weight to external evidence). Conversely, AASB1041 required cash flow estimates to be based on market participants' expectations (AASB1041 para 5.1.10) (para 33(a)).
 - most recent budgets approved by management (for a maximum period of five years unless longer is justified) (para 33(b)).
 - and extrapolated using a steady or declining growth rate (unless an increasing rate can be justified but not to exceed the long-term average growth rate for the products et al) (para 33(c)).
- *Future cash flows* must be estimates for an asset based on its *continued use* (paras 39-44) and in *its current condition* (para 44-49).
 - This includes:
 - cash flows from a committed restructuring (para 47);
 - future cash flows to maintain the level of economic benefits expected to arise from an asset in its current condition (para 49).
 - Estimates of cash flows must exclude:
 - certain cash flows or related cash flow savings from a future restructuring that an entity is not yet committed to or improving or enhancing an asset's performance (para 44); and
 - cash flows from financing or tax (para 50).
- A *cash generating unit* is defined as "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" (para 6). However, AASB 136 specifies *different levels of aggregation at which impairment is assessed* (than AASB 1010 specified) (see 'how to identify a cash-generating unit' following).

- *Extensive guidance is provided on:*
 - *how to identify the cash-generating unit* to which an asset belongs (para 66-79). Importantly, it specifies *different levels of aggregation at which impairment is assessed* (than AASB 1010 specified). For example:
 - a cash-generating unit includes a group of assets for which an active market exists even if some of the output is used internally (para 70).
 - how management monitors the entity's units (such as product lines, business or locations) or how management decides on the continuation of units must be taken into account in identifying whether cash flows are independent (para 69).
 - *how to determine the impairment loss for cash-generating units and goodwill*. (paras 39-43, 66-108 & 134-137). For example:
 - *how to allocate goodwill to cash-generating units* (paras 80-90). This involves both a 'bottom up' and 'top down' test;
 - *how to allocate corporate assets to cash-generating units* (paras 100-103);
 - *how to calculate the recoverable amount of a cash generating unit where the owner has a restoration liability* (by eliminating the restoration liability from both the carrying amount of the asset and the cash flows) (paras 39- 43 and 78).

Illustrative examples of the above (that are not part of the standard) are provided after the appendix.

- An impairment loss (defined in para 6) is recognised in the Income statement (para 60). However, impairment of an asset recognised at a revalued amount is treated as a revaluation decrement (para 60).

Disclosures

Additional disclosures are required under AASB 136 compared to AASB1010/AASB1041 including:

- For each class of asset:
 - the amount of impairment losses, and separately, the amount of reversals of impairment losses, recognised in the income statement and the line items affected;
 - the amount of impairment losses on revalued assets, and separately, the amount of reversals of impairment losses on revalued assets, recognised directly in equity (para 126).
- For each material impairment loss (or reversal) for an individual asset or cash-generating unit:
 - the events/circumstances that led to it;
 - the nature of the asset or cash-generating unit;
 - the segment to which the asset belongs, and the amount recognised by class of asset (or only the amount recognised by class for cash-generating units) (para 130).
- If impairment losses in aggregate are material:
 - the main classes of assets affected;
 - the main events/circumstances that led to it (para 131).
- Segment disclosures (see para 129).

Main differences compared to current Australian requirements

- AASB 136 determines *impairment for all assets* (current, non-current, at cost or revalued), except those subject to another standard that has impairment provisions eg inventories, financial assets covered by AASB 139 *Financial Instruments*, investment properties valued at fair value & non-current assets held for sale, etc (para 2). This scope is wider than covered by AASB1010 and AASB1041, which combined only applied to non-current assets, with different exemptions.
- *Impairment of PP&E is addressed separately (in AASB 136) from the measurement of an asset at cost or fair value (under AASB 116)*. This creates a two step process for valuing PP&E. Previously, under AASB 1041, impairment (or the recoverable amount test) was seen to be part of fair value. This previous approach is considered to be theoretically more correct, but the change has no practical effect.
- AASB 136 *requires an entity to assess at each reporting date whether there is any indication that an asset (or cash-generating unit) may be impaired*. If such indication exists, the entity must estimate the recoverable amount. AASB1010/ AASB1041 did not require an entity to consider indicators of impairment.

- *Recoverable amount* is defined as the higher of an asset's (or cash-generating unit's) fair value less costs to sell *and value in use* (para 6). Previously, AASB1041 para 5.1.9 referred to market selling price.
- *Value in use* is then defined as "the present value of the future cash flows expected to be derived from an asset or cash-generating unit" (para 6). This is effectively the same as the definition of recoverable amount in AASB 1041 & AASB 1010. However, value in use is defined differently for assets of not-for-profit entities that are not dependent on generating net cash inflows (see Impact on the Public Sector below).
- A *cash generating unit* is defined (para 6). Previously, AASB1041 referred to a cash generating operation but did not define it, & AASB1010 referred to a 'group' of assets.
- AASB 136 specifies *different levels of aggregation at which impairment is assessed* (than AASB 1010 specified) (paras 69-70) as discussed above. The implication of this is that the size of a cash generating unit may often be very large. These issues were not addressed in AASB 1041 or AASB 1010.
- AASB 136 (para 33) describes the *method for determining future cash flows*. AASB 1041 & 1010 did not address this.
- AASB 136 (para 31 & 55) requires *cash flows to be discounted to their present value*. AASB 1041 (para 5.1 10) referred to the net present value of cash inflows and AASB 1010 (para 7.3.1) permitted, but did not require, discounting.
- *AASB 136 (para 55-57) describe the discount rate to be used in calculating recoverable amount*. It notes that an entity may *estimate the discount rate taking into account* the entity's weighted cost of capital (the Capital Asset Pricing Model), the entity's incremental borrowing rate, and other market borrowing rates (para 56-7). AASB 1041 & AASB 1010 did not provide any guidance on the discount rate to be used.
- AASB 136 discusses *how to deal with goodwill in testing for impairment* (para 81 & 90) and the order of writing down impairment assets ie goodwill is written down first (paras 104-105). AASB 1041 covered this briefly at para 5.1.9 but AASB 1010 did not address this.
- AASB 136 requires the impairment of *corporate assets* to be addressed at the cash-generating unit level (para 101-2). AASB 1041 & AASB 1010 did not address this issue.
- AASB 136 states that the *unwinding of the discount* for an asset measured at present value is not a reversal of an impairment, because the service potential of the asset has not increased (para 116). AASB 1041 & AASB 1010 did not address this issue.

Impact on the public sector

- For PP&E, little difference in practice is expected, because Treasury's policy *Valuation of Physical Non-current Assets at Fair Value* (TPP 03-02) incorporates the principles in the standard, based on exposure drafts to the current AASB 136. In particular:
 - AASB 136 para Aus 6.2 defines a not-for-profit entity as "an entity whose principal objective is not the generation of profits". This is a significant change, because AASB1010 defined a profit-seeking entity as an entity that had profit as one of its objectives.
 - Following from the above, "assets of *not-for-profit entities* that are not primarily dependent on the asset's ability to generate net cash flows, and where the entity would, if deprived of the asset, replace its remaining future economic benefits, *value in use shall be determined as the depreciated replacement cost of the asset.*" This in effect exempts these assets from the impairment provisions (para Aus32.1). Conversely, AASB 1041 achieved the same by saying that specialised assets that are not part of a cash-generating operation are valued at market depreciated replacement cost, and AASB 1010 para 2.1 explicitly exempted such assets from the recoverable amount provisions. Therefore, there is no impact in practice.
 - Treasury's policy requires the use of management's estimates of cash flows for specialised assets and the use of discounted cash flows, as now required by AASB 136.

- AASB 136 para Aus 32.2 states that replacement cost is measured by reference to the lowest cost at which the gross future economic benefits of the asset could currently be obtained in the normal course of business. AASB 1041 para 5.1.9 merely stated that the best indicator of market buying price is the replacement cost of the remaining economic benefits. But Treasury's policy includes, not only the AASB 136 definition, but also extensive additional guidance based on the concept of 'incremental optimisation'.
- *AASB 136 (para 55-57) describe the discount rate to be used in calculating recoverable amount.* AASB 1041 & AASB 1010 did not provide any guidance on the discount rate to be used. However, Treasury will continue to mandate the use of the weighted average cost of capital
- Impairment of goodwill and intangible assets is not expected to have a significant impact in the NSW public sector.

Policy and Implementation issues (see attached)

Policy and Guidance

- Treasury will update its policy *Valuation of Physical Non-current Asset at Fair Value* to reflect AASB136, but there are no substantive differences.

Mandating Options

- Treasury will continue to mandate that cash flows be discounted at the weighted average cost of capital.

Implementation Issues

- All entities must assess all assets covered by AASB 136 for indicators of impairment or impairment as at 1 July 04 to ensure that the opening balance of all such assets are valued in accordance with the requirements of AASB 1 and AASB 136.
- For PP&E, all NSW public sector entities have valued PP&E in accordance with both AASB 1041 *Revaluation of Non-Current Assets* which includes an impairment test and Treasury's policy *Valuation of Physical Non-current Asset at Fair Value* for years commencing on or after 1 July 02. That policy incorporates all substantive principles now in AASB 136, as discussed above. Therefore, AASB 136 should have little effect. This is especially so because AASB 1041 required entities to revalue PP&E as frequently as necessary to ensure that the carry amount is not materially different from fair value.

This summary has been written in general terms and is intended for general reference only. Agencies should review the contents of the AASB Standard to determine its application in particular circumstances.

SUMMARY OF POLICY, IMPLEMENTATION & SYSTEM ISSUES
AASB 136 “IMPAIRMENT OF ASSETS”
TREASURY & AGENCIES

	Issue	Treasury Policy		System/ Implementation Issue	Mandate Options for GFS Harmonisation	Budget/ Total State Sector Issues
		Mandate Option	Additional Guidance			
1	Fair value guidance ie update Treasury’s Policy on Valuation of Physical Non-Current Assets at Fair Value TPP 03-02		√			
2	Discounting cash flows	√ Mandate use of WACC	√			
3	Assess all assets for indicators of impairment and assess goodwill and indefinite life intangibles for impairment as at 1 July 04			√		