CHAPTER 1

Key accounting and financial reporting issues - Impairment of non-financial assets

The current economic environment in the world poses several geopolitical challenges and is facing the weaning effects of the pandemic. These challenges are expected to have (or have already had) an adverse effect on companies. It would be essential to understand the impact on the assets of the companies. There could be indicators of impairment and which may require companies to perform impairment testing and provide disclosures. Thus, impairment testing of nonfinancial assets and disclosures of impairment testing become imperative.

With this background, in this issue of key accounting and financial reporting issues, this article highlights key areas that regulators have provided improvement points in the area of **impairment of non-financial assets**, and will also provide illustrations of disclosures from thematic reviews performed by the Financial Reporting Council (FRC).

Source

While preparing this article, we have referred to:

- The recent observations of the National Financial Reporting Authority (NFRA)
- The Ind AS observations of the Financial Reporting Review Board (FRRB) of the Institute of Chartered Accountants of India (ICAI)
- The report- Annual Review of Corporate Reporting (2022/23) issued by the Financial Reporting Council, and
- Recent ESMA[1] enforcement directions.

1. European Securities and Markets Authority.

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Key issues and recommendations pertaining to impairment of non-financial assets

Some of the key issues and recommendations pertaining to impairment of non-financial assets is given below:

Disclosures

- ***Key inputs and assumptions:*** IAS 36, *Impairment of Assets* requires an entity to provide disclosures in respect of each individual Cash Generating Unit (CGU) on which the carrying amount of the goodwill or intangible asset with indefinite useful lives allocated to the CGU is significant in comparison to its carrying amount. These disclosures *inter alia* include the key inputs and assumptions used in impairment testing[2], such as key assumptions and period on which cash flow projections are based, growth rates used to extrapolate cash flow projections, discount rates applied, etc.

IAS 36 also states that management may use cash-flow projections/budgets over a period of five years, provided it is confident about its reliability. In such a case, appropriate disclosures which justify the use of such long-term budgets should be made.

- ***Disclosures of impairment loss and reversals:*** As per IAS 36, companies are *inter alia* required to disclose:
  - The amount of impairment losses recognised in profit or loss during the period and the line item(s) in which they have been recorded
  - The amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) in which these amounts have been reversed
  - For each material impairment loss recognised or reversed during the period, the events or circumstances that led to the recognition or reversal of the impairment loss.

In this regard, it has been clarified that an impairment reversal should not be considered as a prior year adjustment.

2. Key assumptions are those to which the unit's (or group of units') recoverable amount is most sensitive.

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Example 1: An entity discloses the events and circumstances that led to the recognition of the impairment loss (a regulatory change as a trigger)

In May 2018, the DCMS concluded its Triennial Review of stakes and prizes and announced maximum stakes on B2 gaming products are to be reduced from GBP100 to GBP2, with the change being brought into effect from 1 April 2019. A regulatory change of this nature is unprecedented and its impact on customer behaviour will not be known until some years after implementation. Based on a series of assumptions, preliminary estimates suggest that this could reduce the Retail segment's annualised adjusted operating profit following mitigation measures by GBP70-100m, based on the size of the retail estate at the time of the announcement in May 2018.

Example 2: An entity discloses the events and circumstances that led to the recognition of the impairment loss (description of industry challenges and external market trends)

During 2018, the UK New car market declined by 6.8% (source: SMMT), continuing the weak trend from 2017, with the sale of diesel vehicles down 29.6%. In addition, the supply imbalance and the elevated level of pre-registration activity resulted in pressure on both New and Used margins. In light of this and the recent performance of the Retail business in the UK, the Board has reassessed its short and medium-term forecasts and has updated the impairment test for the UK Retail CGU group based on a value in use calculation.

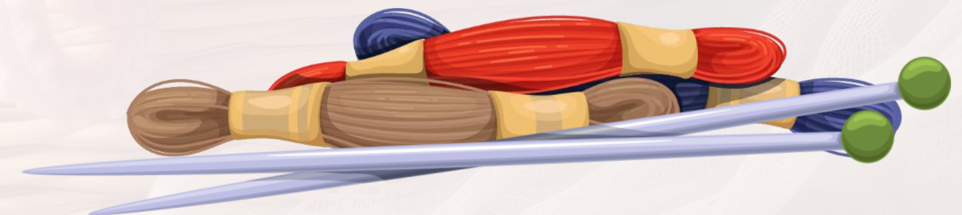
(Source: Thematic review- Impairment of non-financial assets, issued by FRC in October 2019)

- ***Disclosure of accounting policies:*** IAS 36 requires entities to test goodwill acquired in a business combination for impairment annually, irrespective of whether there is any indication of impairment. This should be appropriately disclosed in the accounting policy of the company (refer example policy).

Example policy

The consideration transferred in the acquisition is generally measured at fair value, as are the identifiable net assets acquired. Any goodwill that arises is tested annually for impairment (see Note X)…

(Source: KPMG in India's analysis, read with Guide to annual financial statements – illustrative disclosures issued by KPMG IFRG Limited in 2023)



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Consistency

- ***Consistency of assumptions:*** As per IAS 36, estimates of future cash flows and the discount rate should be consistently used throughout the report[3] and reflect consistent assumptions about price increases attributable to general inflation. Thus, discount rates used for computing the Value In Use (VIU) should be consistent with other information in the annual report and with the general economic environment.

  Further, cash flow assumptions should be consistent with the way the discount rate is determined, otherwise the effect of some assumptions would be counted twice or ignored.

  For example, nominal cash flows, which include the effect of inflation, should be discounted at a nominal discount rate, and real cash flows, which exclude the effect of inflation, should be discounted at a real discount rate ***(Refer example- risk adjustment for cash flows)***.

Risk adjustment for cash flow

Suppose an asset is expected to give rise to one of the following possible cash inflows in three years' time and that the risk-free rate of return is 5 per cent.

Likelihood of cash flow (A)	Cash flow (B)	Expected value (C) = (A)*(B)
25 per cent	GBP100	GBP25
50 per cent	GBP150	GBP75
25 per cent	GBP200	GBP50
Total		**GBP150**

Discussion

The expected value[4] of the cash inflow in three years' time is GBP150. However, there is the possibility that the cash flow will not be GBP150, but GBP100 or GBP200. Market participants are risk-averse and would accept a certain promise of, say, GBP140 in three year's time. We can express the effect of the uncertainty (risk) in calculating the present value by:

a. Discounting the certainty equivalent of GBP140 at the risk-free rate of 5 per cent, giving a present value of GBP121, or

b. Discounting the expected cash flow of GBP150 at a risk-adjusted rate that will give the present value of GBP121, i.e. a rate of 7.4 per cent.

(Source: Thematic Review: Discount Rates, issued by the Financial Reporting Council issued in May 2022)

3. Assumptions used for impairment should be consistent with those in the going concern and viability assessments.
4. The expected value of GBP150 in this example is the probability weighted calculation of the estimated future cash flows. It is not risk-adjusted.

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- ***Consistency of information:*** Where information elsewhere in the annual report and accounts include details of events or circumstances that are indicators of potential impairment, this should be appropriately included in the impairment assessment and disclosures.

  For example, when net assets or carrying amount of subsidiaries in their parent company accounts exceeds their market capitalisation it is an indicator of impairment.

  Similarly, where a company identified significant climate related risks to certain parts of its businesses, then these should be considered as indicators of impairment[5] (refer case study).

Case Study

ESMA, in its 27th extract of its enforcement decisions has issued a case study on how climate risk disclosures would impact the impairment tests and disclosures. This is given below.

An entity which manages airports in several locations, was highly exposed to climate change because of high amounts of Carbon dioxide (CO2) emissions. In the non-financial information section of its annual financial report, the entity included detailed information on how climate change affects its business and also provided its commitment to reduce CO2 emissions by 2025.

Impact on impairment tests

In accordance with IAS 36, the entity should disclose more information on how climate change and the financial impact of the commitment to reduce CO2 emissions were factored in the impairment tests – i.e. how these were taken into account in the determination of the VIU of the CGU.

More specifically to comply with the requirements of IAS 36 and IAS 1, *Presentation of Financial Statements*, the entity should:

- Specify that the costs of the carbon emission commitments are considered in its free cash flows projections as they are not considered to be linked to future restructuring and will not improve or enhance the asset's performance
- Explain the modification of the airport traffic hypothesis (one of the key assumptions considered by the entity) and the external sources used with further explanations on the expected impacts of environmental transition on the traffic, and
- Explain how the modification of the airport traffic affects the growth rate, and
- Disclose a sensitivity analysis of the recoverable amounts to a reasonable variation of the assumptions used which were related to climate change (mainly airport traffic and annual growth rate).

(Source: 27th extract from the EECS's Database of Enforcement issued by ESMA on 29 March 2023)

5. It is better to provide a single, thorough explanation – cross-referenced from the Strategic Report and other sections – than scattered superficial or repetitive commentary.

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- ***Assets to be considered in current condition:*** As per IAS 36, future cash flows should be estimated for the asset in its current condition. Estimates of future cash flows should not include estimated future cash inflows or outflows expected to arise from a future restructuring to which an entity is not yet committed or improving or enhancing an asset's performance[6].

  Accordingly, estimated future cash outflows for meeting carbon reduction targets or restructuring programmes should not be considered. Further, when VIU disclosures cross refer to forecasts used in going concern and viability assessments, it should be made clear how any costs and benefits in those forecasts that related to future improvement to assets or restructuring activities have been addressed for the VIU calculation.

- ***Details of CGUs to be consistent with other information:*** Descriptions of CGU and explanations of how they have been determined should be consistent with information about the company's operations which is mentioned elsewhere in the report and accounts (refer CGU disclosure 1).

  For example, a retailer which operates through an online platform and has physical stores as well should clearly define how it identifies its CGU (refer CGU disclosure 2).

CGU disclosure 1: Explanation by a restaurant on how it has determined CGUs

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.

CGU disclosure 2: Allocation of sales by a retailer having both physical and online stores

Judgement is required as to whether E-commerce sales (and associated costs) could be attributed to stores for the purposes of impairment testing when calculating the value in use of each store CGU. While management believes that a proportion of E-commerce sales could be attributed to stores, the basis of such attribution was difficult to determine, due to insufficient evidence to reliably estimate. For this reason, only iKiosk and Click & Collect E-commerce sales have been deemed directly attributable to a store within the individual store CGU value in use calculations. Attributing 10% of unallocated e-commerce sales and the related costs, would decrease the impairment and onerous lease charge by GBP1.5m and GBP7.7m respectively.

(Source: Thematic review- Impairment of non-financial assets, issued by FRC in October 2019)

6. The cash inflows referred to in IAS 36 would reflect the benefits that are expected to arise from a future restructuring to which an entity is not yet committed or that are expected to arise from enhancements to assets.

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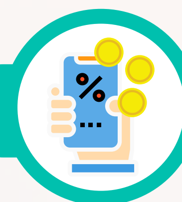

Sensitivity

Performing a sensitivity analysis: The requirement for sensitivity analysis is given below:

For impairment losses recognised or reversed, there is no requirement in IAS 36 paragraph 130 for a sensitivity analysis. However, as per IAS 1, paragraphs 125 and 129, the entity should disclose estimation uncertainty where there is a significant risk of a material adjustment in the following year. However, regulators expect such disclosures to include sensitivity analysis or the range of reasonably possible outcomes.

For CGUs with goodwill or indefinite life intangibles, sensitivity is only required by IAS 36 when a reasonably possible change would completely erode headroom. However, voluntary disclosures would be helpful in other cases. Disclosure of estimation uncertainty may be required by IAS 1, for example where changing the assumptions could erode headroom and give rise to a material impairment loss in the following year[7].

A sensitivity analysis should disclose the impact of reasonably possible changes of assumptions, such as key cash flow assumptions, terminal value growth rates and discount rates. This should be appropriately disclosed in the financial statements. This becomes particularly important where increased economic uncertainty has widened the range of possible outcomes and there is a lower amount of the headroom[8].

When reasonably possible changes in assumptions would result in a recoverable amount below the carrying amount, companies should provide quantitative disclosures about the amount of headroom, the key assumptions, or the sensitivity of the headroom to changes in the key assumptions (refer example disclosure).

7. Source: Thematic review- Impairment of non-financial assets, issued by FRC in October 2019
8. Headroom is the excess of the recoverable amount of a CGU or asset over the carrying amount of that unit.

Example: Headroom sensitivity to changes in key assumptions

The Directors performed sensitivity analysis on the estimates of recoverable amounts and found that the excess of recoverable amount over the carrying amount of the ABC group of CGUs would be reduced to nil as a result of a reasonably possible change in the key assumption of sales growth in the cash flow forecasts*. The Directors do not consider that the relevant change in this assumption would have a consequential effect on other key assumptions#.

The excess of the ABC group of CGUs' recoverable amount over its carrying value is GBPXm. The value assigned to the sales growth assumption is 5% in years 1-3 of the forecast period and 3% in years 4-5. The recoverable amount would equal the carrying value if sales growth were reduced by 1.5% throughout the forecasting period$.

For the XYZ group of CGUs, the Directors do not consider that any reasonably possible changes to the key assumptions would reduce the recoverable amount to its carrying value@.

Note

*: This identifies the key assumption whose change in value causes the erosion of headroom.

#: This shows that management has considered consequential effects of the change on other assumptions.

$: This provides the information required by IAS 36. Additional information may be helpful to users, but it should not displace the required disclosures.

@: This confirms the comprehensiveness of management's review.

(Source: Thematic review- Impairment of non-financial assets, issued by FRC in October 2019)

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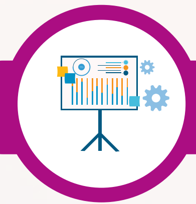
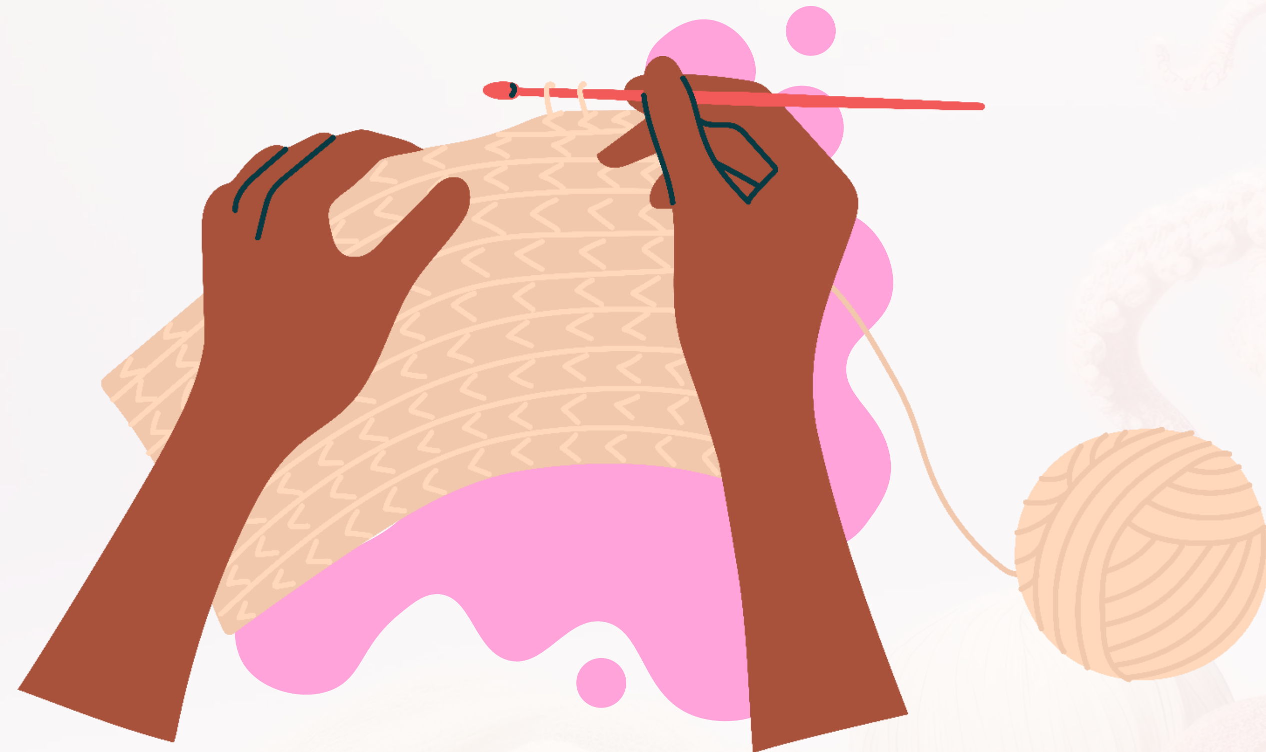


Other

Indicators of impairment: IAS 36 provides an indicative list of impairment indicators, which entities should consider, as a minimum, when assessing whether an asset is impaired. However, when an entity incurs consistent losses, there is erosion of the net worth and default in the payment of loans taken from financial institutions, these are also impairment indicators.



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