IFRS News

Emerging issues and practical guidance*

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Impairment of non-financial assets in the current crisis

The last 12 months have been marked by increased volatility in global markets. The widespread slowdown means that assets and businesses in many industries will generate lower cash flows than expected, increasing the likelihood that impairment charges will be required. Olivier Scherer, Mary Dolson and Dave Walters discuss the issues and introduce two publications designed to help with impairment testing: PwC's *Questions and answers on impairment of non-financial assets in the current crisis* and *Top ten tips for impairment testing*.

The current economic environment has driven businesses in most, if not all, sectors of the economy to revise budgets and forecasts and acknowledge broad expectations of lower cash flows from existing assets. This increases the likelihood that impairment charges may well be required on non-financial assets. Certainly, many more companies will be performing impairment tests at year end or updating tests done earlier in the year. IAS 36, 'Impairment of assets', is one of the more complicated standards, and this can make getting the accounting and disclosures right more of a challenge.

PwC has compiled a set of questions and answers on impairment testing of non-financial assets specifically in the current economic conditions. Several of these Q&A are reproduced below; additional questions and answers, as well as further detail on the questions below, are also available (see weblink below). The questions attempt to provide practical guidance on impairment indicators to look out for, timing of impairment tests, suggestions on how to do an impairment test in volatile markets and what disclosures are critical to the market and regulators in the current environment.

A companion publication, *Top ten tips for impairment testing*, looks at some of the inherent complexities of applying IAS 36 – always challenging – and provides further practical insights. *Questions and answers on impairment of non-financial assets in the current crisis* and *Top ten tips for impairment testing* can be downloaded or ordered through the website pwc.com/ifrs.

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Is the economic crisis an impairment indicator?

An economic downturn would not always be considered a triggering event for impairment testing in its own right. However, the individual economic phenomena that make up the crisis may well be indicators for many companies. Almost all businesses will be impacted by one or more of the economic factors, even businesses that are expecting to weather the downturn or take advantage of the crisis. The market expectation is that many preparers across most, if not all, industries will perform or update impairment tests prior to this coming year end.

The following impairment indicators might be particularly relevant:

- FY08 actual figures significantly lower than the original budget.
- Cash flow significantly lower than forecast.
- Material decreases in expected mid-term and/or long-term growth rates.
- Significant or prolonged decrease in the entity's stock price.
- Market capitalisation less than book value of net assets.
- Announced change in business model, restructuring, discontinued operations, etc.
- Increase in the entity's cost of capital.
- Change of market interest rates or other market rates of return.
- Volatility of relevant foreign exchange rates or commodity prices.
- Deferral of investment projects.

Other indicators that suggest lower cash flows than previously expected may also present themselves.

What is the most significant variable or input for a year-end impairment test?

Every input to the value in use or fair value less cost to sell calculation should be assessed in the current economic conditions, and the inputs should present a coherent picture. The overall key driver that determines the amount of any impairment charge will be the cash flow forecasts. All of the key inputs to the cash flow forecast should be re-assessed in the current climate.

Discount rates are also highly relevant and a change in the discount rate will have an immediate impact on the recoverable amount.

How can impairment tests be more reliably performed in periods of uncertainty?

Almost all impairment tests are performed using a cash flow model. Two approaches to constructing the cash flow model can be considered:
- The 'traditional' approach, which consists of using a 'single set of estimated cash flows and a single discount rate' (IAS 36 A4). Uncertainties are reflected through the risk premium included in the discount rate.
- The 'expected cash flow' approach, which consists of using 'all expectations about possible cash flows instead of the most likely cash flow' (IAS 36 A7). Uncertainties are reflected through probability-weighted cash flows.

The two approaches, theoretically, should provide the same result. However, this relies on a degree of precision in the estimates under the traditional approach that is difficult to achieve. A basic assumption in calculating discount rates is that the expected cash flows fully reflect the uncertainties related to the current economic downturn. Management should consider probability-weighting different scenarios to estimate the expected cash flows.

The expected cash flow approach has, among others, the following advantages in an environment of higher uncertainty:
- The sensitivity of the recoverable amount to uncertainties is explicit in the cash flows compared to the 'traditional' approach where it is factored into the discount rate.
- It enables management to assess the assumptions that may have the most significant impacts on the recoverable amount.
- It calculates a range of expected cash flows instead of only considering the most likely case.
- It may be more aligned with the way management prepares forecasts.
- It lessens the impact of the judgemental exercise inherent in choosing a single specific risk premium, which may be difficult to quantify and document.

What are the consequences of the financial crisis on the discount rate?

The discount rate should reflect the time value of money for the periods until the end of the asset/cash generating unit (CGU)'s useful life, market risks, country risks, risks specific to the assets/CGUs, and other factors that market participants would reflect in pricing the expected future cash flows. Management might use the weighted average cost of capital as a starting point in calculating such a rate.

Despite the financial crisis, the established methods for calculating the cost of capital should continue to be used. However, a reassessment of each input into the calculation and assessment of the overall result is needed and might result in a different discount rate than the one used in prior-year financial statements.

The key components of the discount rate should be viewed over the long term. The equity market risk premium has historically reflected a long-term view and would not be expected to change in the current market. However, other components of the weighted average cost of capital, such as spreads in credit markets, have increased significantly and are highly volatile. The spread level to be retained in the weighted average cost of capital should be assessed on a case-by-case basis.

Determination of the discount rate requires the exercise of judgement. In particular, if the cash flows are not believed to incorporate a sufficient level of risks and therefore cannot be considered as the expected cash flows, the discount rate might

need to be adjusted upwards. It may prove more appropriate to adjust the cash flows for sufficient risk before making any adjustments to the discount rate. It is generally difficult to estimate and support the amount by which the discount rate should be adjusted. To the extent that uncertainties are not reflected in cash flows (for example, through probability-weighting), they may have to be reflected as an additional specific risk premium in the discount rate.

How should a listed associate be tested for impairment when its stock price has significantly declined?

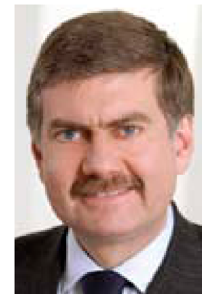
An investor applies IAS 39 to identify potential impairment indicators in an associate accounted for under IAS 28. If any indicators exist, the investment is subject to an impairment test in accordance with IAS 36.

The carrying amount of an associate is not automatically written down to the current share price. The price decline is usually an indicator and establishes the 'fair value less costs to sell' of the associate. However, IAS 36 requires the recoverable amount under value in use also to be calculated before recording an impairment loss. Calculating the value in use implies obtaining cash flow forecasts from the associate's management. Value in use is estimated with assumptions of cash flows taking into account the actual economic environment. However, a listed entity often operates under restrictions about selective disclosure of information. Management of the associate may be unwilling to provide a cash flow forecast or prohibited from doing so by legislation. The investor may need to create its own estimated cash flows using publicly available data or possibly use analyst forecasts. The future expected dividend streams from the investment in associate could also be used in measuring value in use of the associate. Indeed, as the investor's return is based on dividend income, an impairment calculation based on dividend income is comparing like-with-like. As IAS 28 para 33 observes, the dividend approach and the cash flow approach give the same result provided that appropriate assumptions are used.

The investor could also consider the underlying assets of the associate, calculate the investor's share of the value of the assets (which typically is discounted to reflect minority shareholding) and compare it with the carrying amount of the investment in the associate to assess impairment.

Impairments of investments in associates can be reversed in accordance with IAS 36.

Employee benefits in a downturn



Partner in PwC's Global Accounting Consulting Services and leader of the 'Revenue, liabilities and other (RLO)' topic team, Tony Debell, discusses the pension, share-based payment and other RLO issues that management should consider in current market conditions.

Pensions

There are reports in the market that some pension schemes are in surplus. How is this possible?

Let's think about what makes up the pension surplus or deficit recognised on the balance sheet. It comprises the present value of future pension payments less the fair value of the assets held to meet those payments. Management has to make assumptions to measure both future pension payments and plan assets; the interaction of those assumptions will determine whether there is a surplus or a deficit.

The fair value of the plan assets in most pension schemes will have fallen because market prices have fallen, but the present value of pension payments will also have changed. Pension obligations are discounted using the yield on high-quality corporate bonds. As these have generally increased, the discount rate used to value benefit payments has increased, which means the liabilities will be lower. Lower asset values will mean that many pension schemes will have a deficit, but the interaction of falling values and a higher discount rates means that some pension schemes remain in surplus. It is also possible, although uncommon, for the impact of a higher discount rate to be greater than the reduction in plan assets, creating a surplus that did not exist before.

When there is a surplus in a pension scheme, management should remember that IFRIC 14, 'IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction', which provides additional guidance on the recognition of that surplus, applies for the first time for calendar-year 2008 companies.

How can management measure assets and liabilities of pension schemes given the volatility in the markets?

Measuring the obligation to make pension payments in the future and the fair value today of the assets held to meet those obligations requires management to make a number of assumptions.

Firstly, the present value of future pension payments. Market volatility does not directly affect the amounts that pension schemes will pay to employees, but that is not the end of the story. Management still has to estimate the discount rate used to measure the present value of those payments, the inflation rate that will increase the payments and the expected return on the assets held to meet the obligations.

Pension obligations are discounted using the yield on high-quality corporate bonds when there is a deep market for those bonds. Yields have increased as lending has become restricted and prices have fallen, but there remains in many countries a deep market that provides a basis for a reasonable estimate. Management should reconsider the method it uses to determine the discount rate to ensure it is robust, and a wider range of data points or indices might be considered to test the analysis. The range of acceptable discount rates might also be wider, but, where there is a deep market for high-quality corporate bonds – and we believe there is in many territories such as the UK, the US and the Eurozone – management should be able to derive a discount rate.

Management should also estimate inflation, which has begun to fall in many territories, and the expected rate of return on the assets held to meet the pension obligation. Some returns have fallen significantly or even become negative, so judgement is needed to determine the extent to which returns will recover, but the uncertainties to do preclude a reasonable estimate.

Plan assets are measured at fair value, which is straightforward when the assets are traded in an active market. Some pension schemes might hold assets for which there is no longer an active market, in which case management will have to use other valuation techniques and the valuation hierarchy in IAS 39. This might be a more challenging process, but generally the inputs are available, and it should be possible to make a sensible estimate.

The sensitivity of pension scheme assets and liabilities to assumptions used in valuation means that management should consider carefully the disclosures required to make that sensitivity clear.

Share-based payments

What might happen with cash and equity plans given they are probably under water? Do you think there will be re-pricing? Does this trigger a big loss? What is the impact on the income statement?

Falling share prices means the value of share options and other equity-settled share awards held by employees have also fallen. This creates a temptation to modify the awards to increase their value or cancel the awards and replace them with an alternative incentive. Management should think carefully about the accounting implications before taking action. It is straightforward for cash-settled share based payments, as the liability is re-measured at fair value at each period end, with any changes recognised in profit or loss for the period. However, more complex accounting applies on the modification and cancellation of equity-settled share-based payment.

The value of a share option might be increased by re-pricing the option (reducing the exercise price), or altering or removing the conditions that must be met before the option can be exercised. When an option is modified in a way that increases its fair value, the additional fair value is measured at the date of the modification and spread over the remaining period that the employee has to work in order to exercise the option. The modification means there is an extra cost in the income statement to reflect the extra value given to the employee.

The existing share-based payment charge based on the fair value of the option when it was originally awarded continues to be recognised in the income statement over the remaining vesting period. This charge does not disappear, so the impact of the modification is to increase the share-based payment charge.

Cancelling the share-based payment award and replacing it with another incentive may not be the best idea. The award may not have a value to the employee today, but cancellation will result in an immediate acceleration of the share-based payment expense. All of the fair value of the option when it was originally awarded that has not yet been recognised in the income statement will be recorded immediately when the option is cancelled.

What reminders do you have on restructuring provisions? What criteria must be met if management is to meet provisions in the current year?

Management that is considering a restructuring of some sort – maybe reducing the number or employees or closing facilities – should be aware of the criteria that determine when the liability for the restructuring payments is recognised. A restructuring provision is recognised only when the company has incurred an obligation to spend the money. This happens when management has a detailed formal plan for the restructuring and has created a valid expectation among those affected that this plan will be implemented. The creation of the expectation is the key test; simply having a plan is not enough to record a provision.

A valid expectation is normally created by management announcing the plan to the people affected. It is critical for

management, when considering planned restructuring and the accounting for it, to determine when it created the expectation that it would execute the plan.

Management should only include in a restructuring provision those costs that result directly from and are necessarily entailed by the restructuring – for example, employee termination and lease termination. The provision should not include future operating losses or any other expenses that relate to ongoing activity – for example, relocation and retraining.

Do you expect to see companies breaching lending covenants?

Yes, companies that are required to comply with, for example, gearing or interest cover targets might breach these covenants if results are worse than expected, making the related loans repayable on demand.

Management should consider, before the end of the year, whether a breach is likely and discuss the consequences with its lenders. A loan that has become repayable on demand because of a covenant breach at the year end is a current liability even if management subsequently obtains a waiver from the lender. The loan is presented as non-current only if a waiver or a grace period of at least 12 months to rectify the breach is obtained before the year end. A waiver obtained after the year end will not affect the classification of the loan, so early identification of a potential problem that can be discussed with the lender before the year end is important.

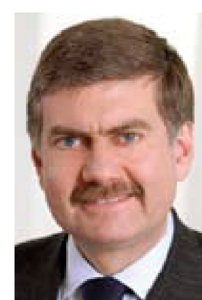
What other issues should management look out for in the current market?

Management that has classified investments in money-market funds as cash and cash equivalents should consider the classification. Market conditions mean that some money-market funds previously classified as cash and cash equivalents are no longer sufficiently liquid or are no longer subject to a sufficiently insignificant risk of changes in value to support this classification. The classification should be considered at each reporting date.

Related-party disclosure is another area to think about. Some government restructuring packages have resulted in governments taking large stakes in financial institutions. These institutions were previously owned by shareholders and no one party had control or significant influence. Now, however, the government might have control or significant influence, so management should be aware of related-party disclosures related to transactions with other government-owned or -influenced entities.

Finally, management might have to consider whether to recognise deferred tax assets. Operating losses, restructuring provisions that are tax deductible only when spent and asset impairments that reduce book value below cost will all create deferred tax assets. Management needs to assess carefully the profits it expects to make in the future to recover those assets. Deferred tax assets should be supported by convincing evidence that there will be profits in the future. Recent losses mean management should have clear objective evidence of why it will become profitable in the future if deferred tax assets are to be recognised.

Going concern assumption: don’t take it for granted



Steve Ralls and Tony Debell from Global ACS central team look at reassessing going concern assumptions in the current market and identify circumstances where management may want to make additional disclosures.

Fifteen years of almost unbroken economic growth and easy credit have made the going concern assumption that underpins all financial reporting a foregone conclusion for many companies and their auditors. The credit crisis and its consequences for all companies mean this is no longer the case. The high-profile liquidity problems suffered by banks, insurance companies, retailers and car-makers demonstrate that remaining a going concern – having enough cash to meet liabilities as they fall due for at least 12 months from the balance sheet date – is now a real issue for many companies.

Going concern is one of the ‘underlying assumptions’ of financial reporting. Financial statements, as explained in the Framework, are ‘prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future’.

If the going concern assumption is not appropriate, financial statements may need to be prepared on a different basis. The ‘different basis’ has seldom been seen in practice but might include a wide range of additional disclosures, impairment of financial and non-financial assets, reclassification of debt from non-current to current and the recording of additional provisions.

The problems began in the financial sector, with banks particularly suffering liquidity problems, but have spread rapidly to other sectors. Liquidity is a shortage of cash and borrowing facilities meaning that obligations cannot be met on time, rather than inherently loss-making operations. Companies that are growing rapidly depend on borrowing facilities to fund expansion. Very few companies, even those that continue to be highly profitable, are immune. Some of the world’s largest

companies have begun to run out of cash. Even apparently creditworthy borrowers have found that finance is at best expensive and at worst not available. Management reporting results early in 2009 should consider carefully if the going concern assumption remains appropriate.

Liquidity problems are caused by a variety of factors. Banks that are unable to borrow are less willing to lend. This means that facilities might not be renewed or might be renewed on more onerous terms, perhaps with more demanding covenants. Credit insurance is being withdrawn, leading to some suppliers demanding earlier payment or even cash on delivery. Suppliers demanding cash on delivery was seen as contributing to two high-profile retail businesses recently going into administration: MFI and Woolworths. Companies that are already suffering cash flow problems try to delay payments, putting pressure on their supplier's cash flows and decreasing confidence among consumers has reduced sales.

Indicators warning that liquidity might become an issue include declining operating cash flows, increased bad debts or slower payment by customers, borrowings that fall due in the near future and facilities that are shortly due for renewal. Some companies are also finding it increasingly difficult to comply with their borrowing covenants – for example, interest cover or gearing – as results deteriorate or assets are impaired. It is important that management identifies these warning signs and takes appropriate action as soon as possible.

Extract from going concern disclosure in interim financial statements of FTSE 100 retailer that passed into administration in December 2008

"These interim financial results have been prepared on a going concern basis, which assumes the group will continue to be able to meet its liabilities when they fall due, for the foreseeable future. The Directors have produced cash flow forecasts which indicate that the Group can continue as a going concern. In preparing those forecasts, the Directors have taken into account the following material uncertainties:

- The current general uncertainties in respect of the UK economic conditions and associated consumer spending habits.
- The importance of the Christmas trading season.
- The increased pressure on working capital, driven in part by credit insurers taking a more adverse view of providing cover to non-food retailers and distributors, and the consequent renegotiations with suppliers of the terms in which they trade with us.
- The extent to which the phasing of inventory purchases can be adjusted or payment terms with our customers can be modified.

Having taken these uncertainties into account, the Directors believe it is appropriate to prepare the accounts on a going concern basis, as they believe the Group can remain within its existing banking facilities. Accordingly, the interims financial information does not include the adjustments that would result from failure to remain a going concern."

Experience shows that the earlier a potential issue is identified, the better the chance that it can be dealt with effectively. Directors may convince themselves that they have a strategy to deal with the problem and not take appropriate action early enough. Management that has not had to deal with banks to negotiate or renegotiate borrowings and facilities for some time might be surprised by the extent to which the world has changed. The key for management is therefore to keep cash flow forecasts and budgets up to date and approach lenders as soon as any potential problem becomes apparent.

Management should consider carefully, on the basis of cash flow forecasts, expected results and available facilities, whether it remains appropriate to prepare the financial statements on a going concern basis. But this is not the end of the story, even if the company remains a going concern. Disclosure is also important, particularly when management's conclusion is based on assumptions that are subject to significant uncertainty. The liquidity disclosures required by IFRS 7 and the critical judgement and estimate disclosures required by IAS 1 should be areas of particular focus.

There is an additional requirement in IAS 1 for specific disclosures when 'material uncertainties' about future events 'cast significant doubt' on an entity's ability to continue as a going concern. It should be clear to users of the financial statements why the company is a going concern, the assumptions on which that conclusion is based and the risks that events may turn out differently.

Auditors should also consider the implications of management's conclusion for the audit opinion. When there is a material uncertainty about an entity's ability to continue as a going concern, the audit opinion should include an 'emphasis of matter' paragraph (see below) that explains the uncertainty and draws attention to the relevant disclosures in the financial statements. The opinion should be qualified if the disclosure in the financial statements is not adequate – this disclosure should include at least a description of the factors causing the uncertainty, the financial impact and management's plans for addressing the issues, and why, given the uncertainties, management still considers it appropriate to use the going concern basis (see financial statement extract below).

Specimen 'emphasis of matter' paragraph to highlight a going concern uncertainty in an ISA audit report on a set of annual financial statements

Emphasis of matter

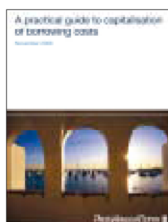
Without qualifying our opinion, we draw attention to Note [X] in the financial statements which indicates that the Company incurred a net loss of [$$$] during the year ended 31 December 2008 and, as of that date, the Company's current liabilities exceeded its total assets by [$$$]. These conditions, along with other matters as set forth in Note [X], indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern.

PwC's most recent IFRS publications

PricewaterhouseCoopers has released a number of IFRS-related publications this quarter. Our guidance covers various accounting topics, outlined below.

'A practical guide' series

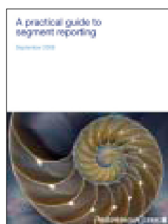
- **Capitalisation of borrowing costs**



The 16-page publication looks at some of the practical implications of applying IAS 23R. The questions and answers cover scope and definitions, borrowing costs eligible for capitalisation, foreign exchange differences, interaction between IAS 23 and IAS 11, transition, first-time adoption and US GAAP differences

- **New IFRSs for 2009**
This publication, mainly in question and answer format, is a high-level practical guide to the new IFRS standards and interpretations that come into effect in 2009.

- **Segment reporting**



This practical guide to applying IFRS 8 provides an overview of key implementation issues, differences between IFRS 8 and IAS 14, first-time adoption of IFRS 8, and over 30 questions and answers (see also our flyer 'Segment reporting – an opportunity to explain the business' summarised below).

- **Share-based payments**
The 48-page publication answers many of the questions that we have been asked in connection with IFRS 2. It contains practical examples to help management draw similarities between the requirements in the standard and their own share-based payment arrangements. It also shares PwC insight and experience from dealing with countless share-based payment arrangements from around the world.

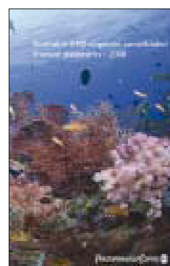
Other publications

- **IFRS disclosure checklist 2008**
Outlines the disclosures required by all IFRSs published up to November 2008.

- **IFRS manual of accounting 2009**
This is PwC's comprehensive global guide to IFRS. It provides practical guidance on all IFRSs. Not available in PDF format.

To order hard copies any of these materials, contact your local PwC office or visit www.cch.co.uk/ifrsbooks. PDFs can also be downloaded, from pwc.com/ifrs

- **Illustrative corporate consolidated financial statements 2008**



This publication provides an illustrative set of consolidated financial statements, prepared in accordance with IFRS, for a fictional manufacturing, wholesale and retail group. It is based on the requirements of IFRS standards and interpretations for financial years beginning on or after 1 January 2008.

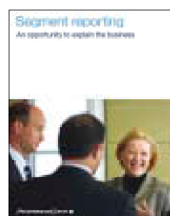
- **Illustrative financial statements 2008 – insurance**
Model financial statements for a fictional insurance company, based on the requirements of IFRS standards and interpretations for financial years beginning on or after 1 January 2008.

- **Illustrative financial statements 2008 – investment funds** Model financial statements for a fictional open-ended investment fund, based on the requirements of IFRS standards and interpretations for financial years beginning on or after 1 January 2008.

- **Illustrative financial statements 2008 – private equity**
Model financial statements for a fictional private equity company, based on the requirements of IFRS standards and interpretations for financial years beginning on or after 1 January 2008.

- **Impairment**
'Questions and answers on impairment of non-financial assets in the current crisis' and 'Top ten tips for impairment testing' (see article on p1 of this edition of *IFRS News*). Available only in PDF format from pwc.com/ifrs.

- **Segment reporting – an opportunity to explain the business'** (flyer)



High-level issues for management to consider when applying IFRS 8, including how the standard will change reporting and what investors want to see.

- **Understanding new IFRSs for 2009 – a guide to IAS 1R, IAS 27R, IFRS 3R and IFRS 8**
This supplement to the manual of accounting provides detailed guidance on the new and revised standards that come into force in 2009. Not available in PDF format.

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