



Spotlight on Accounting Errors

Asset Impairment – Compliance with AASB 136

Part 1 – VIU Impairment Models

A common error arising in financial reporting is the failure to impair a non-financial asset in compliance with AASB 136 *Impairment of Assets* when assessing the recoverable amount of non-financial assets such as:

- Goodwill;
- Identifiable intangible assets; and
- Property, plant and equipment.

All of these assets have to be tested for impairment if there is an indicator the asset is impaired, with goodwill (including goodwill arising from an acquisition in the current year) and certain intangible assets having to be tested for impairment annually, regardless of whether there is an indicator of impairment.

If an impairment test is required, the entity must determine the asset's recoverable amount and recognize an impairment loss if the asset's carrying amount is greater than its recoverable amount.

AASB 136 allows the entity to choose to determine the asset's recoverable amount either by:

- The Value in Use (VIU) Method or
- The Fair Value less costs of Disposal (FVLCD) approach

Errors arise when management prepare a discounted cash flow model and then refer to it as either a 'fair value less costs of disposal' (FVLCD) model or a 'value in use' (VIU) model without understanding that AASB 136 and AASB 13 *Fair Value Measurement* provide strict guidelines on how asset impairment models are to be prepared.

Whilst estimating an asset's recoverable amount requires judgement and estimation, the rules provided in AASB 136 cannot be ignored. In this Spotlight on Accounting Errors, being Part 1 of a series where we consider common errors in determining the recoverable amount of non-financial assets, we examine common errors in VIU models.

In future editions we will put the spotlight on:

- Part 2, common errors in fair value less cost of disposal (FVLCD) impairment models;
- Part 3, errors in when to test for impairment and what to test for impairment; and
- Part 4, errors in the discount rates applied in discounted cashflow impairment models.

Common Issues with VIU Impairment Calculations

The common errors in VIU models relate to a failure to correctly apply the requirements of AASB 136, failing to:

- Reflect expectations about possible variations in the amount or timing of future cash flows;
- Base cash flow projections on reasonable and supportable assumptions;
- Apply a maximum period of 5 years for cash flow projections or if greater than 5 years, subject to the specific restrictions within AASB 136;
- Exclude the effect of capital improvements or restructuring; and
- Include the cost of servicing the asset.

Variations in the amount and timing of future cash flows

AASB 136 paragraph 30 states:

The following elements shall be reflected in the calculation of an asset's value in use:

(a) an estimate of the future cash flows the entity expects to derive from the asset;

*(b) expectations about **possible variations in the amount or timing of those future cash flows**;*

(c) the time value of money, represented by the current market risk-free rate of interest;

(d) the price for bearing the uncertainty inherent in the asset; and

(e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

A fundamental error is not to address the risk associated with forecast net cash flows from the possible variations in the amount and/or timing of those future cash flows. Uncertainty as to the timing of cash flows or the market's assessment of risk in the assets is to be taken into account either by adjusting the cash flows or the discount rate (AASB 136 paragraph 32). The intention is that the VIU should be the present value of those future cash flows.

AASB 136 Appendix A provides guidance on the use of present value techniques in measuring VIU and notes that there are two approaches that can be adopted:

- The Traditional Approach – using a single set of estimated cash flows and a single discount rate; or
- The Expected Cash Flow Approach – using all expectations about possible cash flows instead of the single most likely cash flow. The expected cash flow approach allows use of present value techniques when the timing of cash flows are uncertain.

AASB 136 Appendix A notes that the transitional approach may not appropriately address some complex measurement problems, such as the measurement of non-financial assets for which no market for the item or a comparable item exists.

Common Error

All too often cash flows used in VIU models ignore the risk that cashflows will be lower than forecast or will be received later than forecast.

AASB 136 requires the forecast cashflows to be reasonable supportable, so preparers are prohibited from using overly optimistic forecasts, but if the estimates are aggressive and optimistic as to quantum of cashflows forecast to be received and/ or the timing of cash inflows, the discount rate must be reflected in a higher discount rate.

All too often the discount rate used for cashflow projections of start up business, entering new markets, with little history of being able to reliably predict quantum and timing of cashflows, have comparable discount rates to stable, well established and easily predictable cashflows.

Basis for Estimates of Future Cash Flows

AASB 136 paragraph 33 states:

In measuring value in use an entity shall:

*(a) base cash flow projections **on reasonable and supportable assumptions** that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. **Greater weight shall be given to external evidence.***

*(b) base cash flow projections on the most recent financial budgets/forecasts approved by management, but shall **exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance.** Projections based on these budgets/forecasts shall cover a **maximum period of five years, unless a longer period can be justified.***

*(c) estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by **extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified.** This growth rate shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified.*

Common Error

A common error in preparing VIU models is that the forecasts are neither reasonable nor supportable, being overly optimistic, driven in many cases by the desire to ensure the recoverable amount is higher than the carrying amount.

Such overly optimistic, unrealistic and unsupported forecasts can usually be identified as:

- They are not in line with past performance;
- They are 'hockey stick forecasts' with significant improvements in the latter years that simply not be supported;
- They are not in line with actual performance in the months after the year end; and
- The market capitalization of the entity is significantly below the net assets of the entity.

Reasonable and supportable assumptions

AASB 136 paragraph 34 requires the following:

*Management assesses the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows. Management shall ensure that the **assumptions on which its current cash flow projections are based are consistent with past actual outcomes**, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.*

Common Error

A common error is that cashflow forecasts are not in line with historic actual performance and management fails to analyze and document the reasons for this.

If actual cash flows have been consistently below projected cash flows, then management have to investigate the reason for it and assess whether the current cash flow projections are realistic or require adjustment.

Common Error

A common error is for the cash flow projections applied in VIU models to be based on budgets that include stretch target earnings goals, a 'best or better-case' scenario of predicted earnings rather than the 'most likely' scenario. The use of such cash flows is inappropriate and fails to meet the requirement of reasonable and supportable assumptions.

Common Error

The forecasts in the VIU model should be in line with the company's budgets and forecasts, a common error is that the forecasts are not in line with the company's budgets and forecasts. This can arise because:

- The preparation of the VIU model is prepared by a separate team than those preparing the budgets;
- Budgets get updated whilst the VIU model has not been updated;
- The VIU model deliberately uses forecasts that are greater than those in the budget to avoid incurring an impairment charge; and
- The entity only prepares annual budgets, rather than a year plan.

Forecasts for a maximum of five years

AASB 136 paragraph 35 states:

*Detailed, explicit and reliable financial budgets/forecasts of future cash flows for periods longer than five years are generally not available. For this reason, **management's estimates of future cash flows are based on the most recent budgets/forecasts for a maximum of five years**. Management may use cash flow projections based on financial budgets/forecasts over a period longer than five*

*years if it is confident that these projections are reliable and it can **demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.***

Common Error

A common error is to extend the forecast period past 5 years, when the entity has no evidence of being able to reliably forecasts for that period.

Common Error

A common error in VIU models is that they use increasing cash flows after five years that exceed long-term average growth rates and without considering the offsetting impacts on discount rates. Projections beyond five years need to be able to be justified and should apply a steady or declining growth rate for subsequent years on the basis that when conditions are favorable, competitors are likely to enter the market and restrict growth. Consequently, entities will have difficulty in exceeding the average historical growth rate over the long term. (AASB 136 paragraphs 36 and 37).

Common Error

An error is to incorrectly assume an asset will generate cash infinitely when the asset has a finite life. Such assets include:

- Major manufacturing facilities
- Patents
- IP
- Licenses
- Intangible assets with finite lives
- Property plant and equipment with finite lives

Common Error

A common error is for entities to use 'hockey stick' forecasts, where the asset's performance is forecast to improve towards the end of the forecast horizon. It is only in exceptional circumstances should an increasing growth rate be used or should the period before a steady or declining growth rate be assumed to extend more than five years.

Capital Improvements and Restructuring

Whilst a part-completed asset must have the costs to complete it included in the cash flows, the general rule is that future cash flows should be forecast for assets in their current condition.

AASB 136 paragraphs 44 states:

*44. Future cash flows shall be **estimated for the asset in its current condition**. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:*

- (a) a future restructuring to which an entity is not yet committed; or
- (b) improving or enhancing the asset's performance.

Common Error

A common error in VIU models particularly those relating to goodwill arising on a newly acquired business where the synergistic benefits of planned future restructuring and integration of the business, with a view to having savings through a reduced head count and reducing duplication of functions (such as administration and human resources) but which the entity is not committed, is incorrectly included within the VIU model.

Servicing assets

Whilst improving capital expenditure may not be recognised in a VIU model, routine and replacement capital expenditure necessary to maintain the function of the asset has to be included.

AASB 136 paragraph 49 states:

Estimates of future cash flows include future cash outflows necessary to maintain the level of economic benefits expected to arise from the asset in its current condition. When a cash-generating unit consists of assets with different estimated useful lives, all of which are essential to the ongoing operation of the unit, the replacement of assets with shorter lives is considered to be part of the day-to-day servicing of the unit when estimating the future cash flows associated with the unit. Similarly, when a single asset consists of components with different estimated useful lives, the replacement of components with shorter lives is considered to be part of the day-to-day servicing of the asset when estimating the future cash flows generated by the asset.

Common Error

It is an error to not include future cash flows necessary to maintain the level of economic benefits expected to arise from the asset in its current condition and judgement will be required to distinguish between enhancements and maintenance expenditure.

In preparing VIU models it is very common to use EBITDA as the starting point as the basis for predicting future cashflows. If an entity has a policy of capitalizing items of with 3-10 years depreciable life, then EBITDA excludes the cost of these items, which will need replacing over the period of the cash flow forecast period used in the VIU model.

Asset Impairment continues to be a focus of ASIC surveillance activities

In August 2019 ASIC issued Information Sheet 203 *Impairment of Non-Financial Assets: Materials for Directors* to explain the responsibilities directors have regarding the testing of non-financial assets for impairment. ASIC highlighted the common issues they have found from their investigations and corporate surveillance program with impairment calculations.

In December 2022 ASIC Issued Media Release 22-333MR highlighting its focus areas for 31 December 2022 reporting, with Asset Values and Impairment of non-financial assets being on the top of its list. ASIC noted the following:

Asset Values

Examples of matters that may require the focus of directors, preparers and auditors in relation to asset values in the current environment include:

Impairment of non-financial assets

- *Goodwill, indefinite useful life intangible assets and intangible assets not yet available for use must be tested for impairment annually. Entities adversely impacted in the current environment may have new or continuing indicators of impairment that require impairment testing for other non-financial assets.*
- *The appropriateness of key assumptions supporting the recoverable amount of non-financial assets.*
- *Disclosure of estimation uncertainties, changing key assumptions, and sensitivity analysis or information on probability-weighted scenarios.*
- *Key assumptions may include assumptions relating to the factors listed in the covering release.*

Factors listed by ASIC relating to key assumptions

Directors and management should assess how the current and future performance of a company, the value of its assets and provisions, and business strategies, may be affected by changing circumstances, uncertainties and risks such as:

- *the impact of rising interest rates on future cash flows and on discount rates used in valuing assets and liabilities;*
- *inflationary impacts that may differ between costs and income;*
- *increases in energy and oil prices;*
- *geopolitical risks, including the Ukraine/Russia conflict;*
- *impacts of climate change and climate related events;*
- *commitments and policies on climate and carbon emissions by governments;*
- *technological changes and innovation;*
- *changes in customer preferences and online purchasing trends;*
- *the discontinuation of financial and other support from governments, lenders and lessors, including any possible increases in the level of insolvencies;*
- *legislative and regulatory changes; and*
- *other economic and market developments.*

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Wayne is the Managing Director of Basford Consulting. Wayne is highly qualified and experienced in delivering both technical expertise and thought leadership to a national and international audience. Wayne has worked with major global accountancy firms across three continents, developing extensive experience with large, multinational audits. Wayne is a specialist in International Financial Reporting Standards (IFRS). He regularly authors technical papers and newsletters on application of IFRS and Auditing Standards, as well as consulting on application of IFRS and corporate governance.

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