

fasttrack

Financial Accounting-Standards & Technical

Grant Thornton 

Impairment of assets - the minimum requirements

AASB 136 'Impairment of Assets' has made substantial changes to the way we account for asset impairment. AASB 136 has also instituted annual requirements on both companies and their auditors.

The base requirement on all companies is to establish a set of impairment indicators which must be reviewed at each reporting date. If any such indication exists, the entity shall estimate the recoverable amount of the asset. AASB 136 provides the following impairment indicators as a minimum:

External sources of information:

- during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use
- significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated
- market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially and
- the carrying amount of the net assets of the entity is more than its market capitalisation.

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Impairment of assets - the minimum requirements (cont.)

Internal sources of information:

- evidence is available of obsolescent or physical damage of an asset
- significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite and
- evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

Irrespective of whether there is an indication of impairment an entity must perform an impairment test annually for the following:

- intangible assets with indefinite lives
- intangible assets not yet available for use and
- goodwill acquired in a business combination.

The **recoverable amount** of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use.

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

AASB 136 requires the following elements to be reflected in the calculation of an asset's value in use:

- an estimate of the future cash flows the entity expects to derive from the asset
- expectations about possible variations in the amount or timing of those future cash flows
- the time value of money, represented by the current market risk-free rate of interest
- the price for bearing the uncertainty inherent in the asset and
- other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

In measuring value in use the entity shall:

- base cash flow projections on reasonable supportable assumptions
- base cash flow projections on the most recent financial budgets/forecasts approved by management
- exclude cash flows expected to arise from future restructuring (to which the entity is not committed)
- exclude cash flows based on improving or enhancing the asset's performance
- base projections on a five year maximum period (unless a longer period can be justified) and
- estimate cash flows beyond the period covered in the budget/forecast using steady or declining growth rates.

Future cash flow estimates shall not include:

- cash flows from financial activities or
- income tax receipts or payments.

The discount rate used must be a pre-tax rate that reflects the current market assessment of the:

- time value of money and
- risks specific to the asset (not already included in estimating the future cash flows).

Cash Generating Units

If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).

AASB 136 defines a **cash-generating unit** (CGU) 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.

Defining CGUs requires a substantial degree of professional judgement. As such, it is important that a company has provided supportable assumptions as to their selection of CGUs including internal managements structures and reporting.

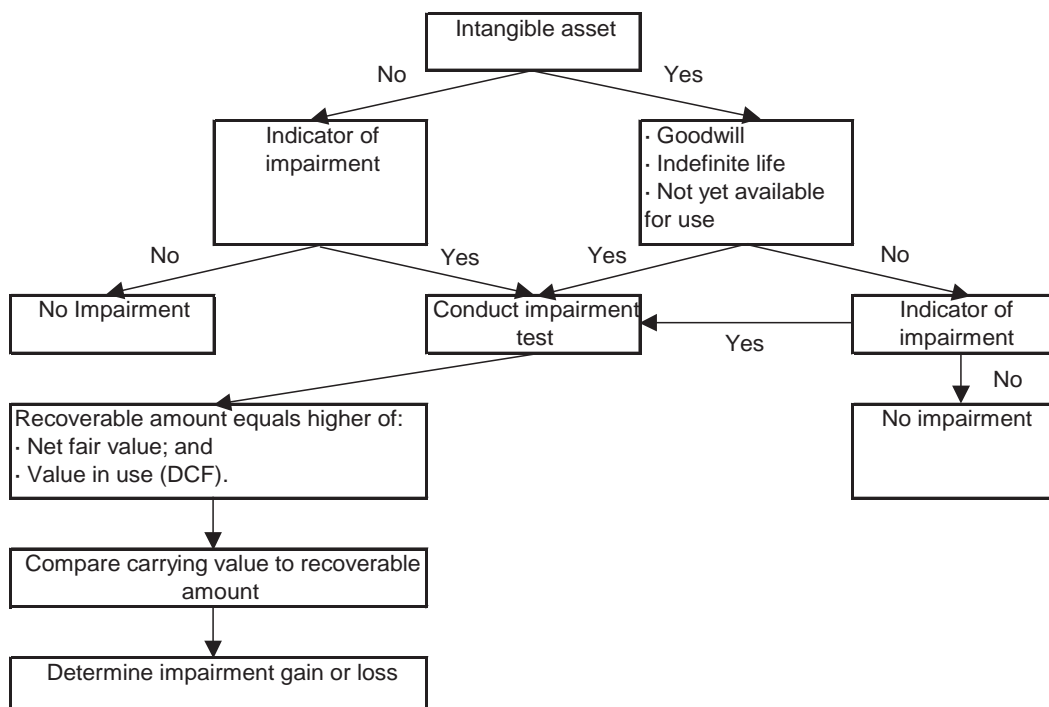
Impairment of assets - the minimum requirements (cont.)

Not-for-profits

AASB 136 provides additional guidance to not-for-profit entities, including:

- where the future economic benefits of an asset are not primarily dependent on the asset's ability to generate net cash inflows 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
- depreciated replacement cost is defined as the current replacement cost of an asset less, where applicable, accumulated depreciation calculated on the basis of such cost to reflect the already consumed or expired future economic benefits of the asset. The current replacement cost of an asset is its cost measured by reference to the lowest cost at which the gross future economic benefits of that asset could currently be obtained in the normal course of business
- an impairment loss on a revalued asset is recognised directly against any revaluation reserve in respect of the same class of asset to the extent that the impairment loss does not exceed the amount in the revaluation reserve for that same class of asset, and
- a reversal of an impairment loss on a revalued asset is credited directly to equity under the heading revaluation reserve. However, to the extent that an impairment loss on the same class of asset was previously recognised in profit or loss, a reversal of that impairment loss is also recognised in profit or loss.

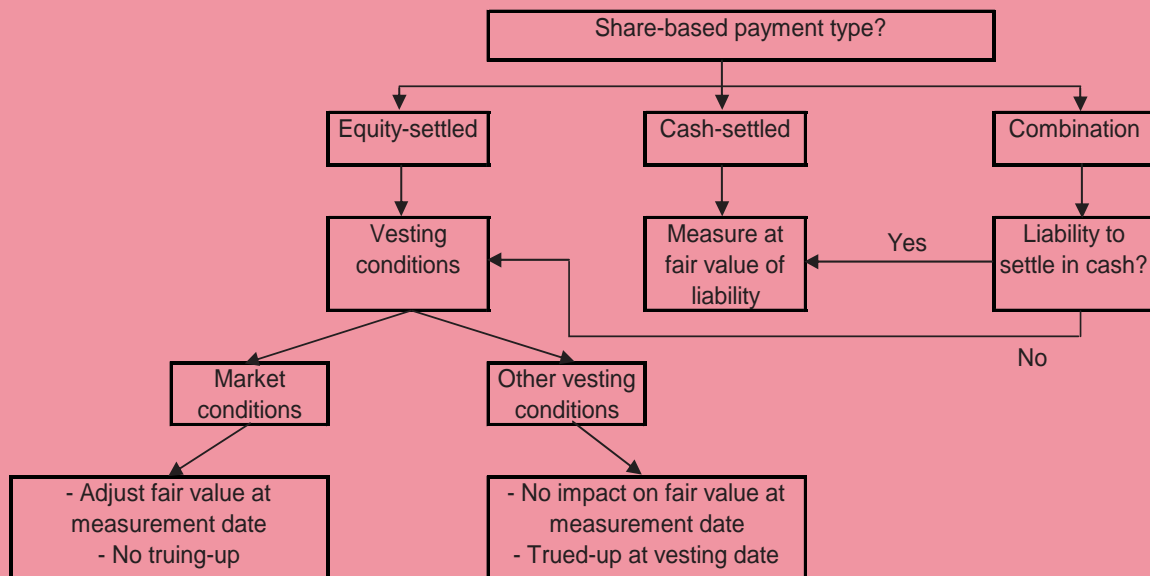
Impairment Decisions Tree



Share-based Payment

Share-based Payment decision tree

Refer to fasttrack issue 35, December 2004 for details, however the following decision tree is a helpful tool to assess the treatment of share-based payment:



Financial Instruments - what you need to know

Hedging

AASB 139 'Financial Instruments: Recognition and Measurement' has instituted a number of new requirements relating to hedge accounting a company must satisfy prior to being able to use hedge accounting.

Hedge accounting attempts to match the timing of profit or loss recognition on the derivative with that item being hedged, but hedge accounting can only be applied when the derivative meets certain criteria. To qualify as a hedge an entity must:

- identify the type of hedging relationship - fair value, cash flow or net investment
- identify the hedge item(s) or transaction
- identify the nature of the risk being hedged and the period being hedged
- identify the type of hedging instrument
- demonstrate that the hedge will be 'highly effective' in reducing risk exposure
- monitor effectiveness.

At each of the steps documentation is required to be prepared and maintained. On transition to A-IFRS a company must ensure that the relevant hedging documentation is developed prior to the date of transition to AASB 139 (i.e. if the exemption not to provide comparatives under AASB 139 is invoked in an entity's first A-IFRS report the documentation is required as at the beginning of actual period).

Assessing hedge effectiveness

A hedge is regarded as highly effective only if both of the following conditions are met.

- At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument.
- The actual results of the hedge are within a range of 80 to 125 per cent.

Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial report. To the extent a hedge is ineffective the ineffectiveness is recorded in the income statement.

Derivatives

AASB 139 requires all derivatives (except those classified as effective hedges) to be classified as Held-for-trading financial instruments and recorded at fair value with variations recorded through the Income Statement.

Loan covenants

The introduction A-IFRS has resulted in a substantial change in many company's Balance Sheets, as such, for many companies this has resulted in a breach of loan covenants. Therefore, it is important that companies review their loan covenants especially for their first set of A-IFRS accounts. The vast majority of financial institutions are aware of the likely impact of the introduction of A-IFRS and are accommodating customers by adjusting covenants to reflect the new A-IFRS position or creating a greater emphasis on cash covenants.

Financial Instruments - what you need to know (cont.)

Allowance for doubtful debts

AASB 139 contains specific requirements for the impairment of financial assets such as Accounts Receivables (Debtors). An impairment assessment is required at each reporting date as to whether there is any objective evidence that a financial asset or liability is impaired. If evidence exists that the carrying value of the asset should be reduced either directly or via a provision.

Indicators of impairment included in AASB 139 are:

- significant financial difficulty of the issuer or obligor
- a breach of contract, such as a default or delinquency in interest or principal payments
- the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation
- the disappearance of an active market for that financial asset because of financial difficulties
- observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
 - adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit card limit and are paying the minimum monthly amount) or
 - national or local economic conditions that correlate with defaults on the assets in the group (e.g. an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

The effect of these impairment requirements is that general provisions for doubtful debts are effectively disallowed. Any provision against financial assets such as accounts receivable must be supported by sufficient objective evidence the group of assets is impaired or uncollectible (e.g. a general provision based on the ageing of the debt may no longer be permitted under AASB 139).

Intercompany loans

Intercompany loans fall within the scope of AASB 139. AASB 139 requires that financial instruments are initially recognised at fair value. This will depend on the terms, conditions and circumstances of the loan, which have been assessed in determining the accounting treatment for the loan.

If there is no stated date for repayment, it will be necessary to determine the accounting based on the expected timing of repayments. Circumstances could include:

- the loan is repayable on demand, indicating it would be appropriate to record the full amount of the loan as a liability
- if the intention is to make the loan available indefinitely, the loan is likely to be in the nature of an investment in the subsidiary
- if the intention is that the loan will be short-term, the loan amount is likely to be an approximation of fair value. This could be the case for inter-company cash accounts or cash pooling/sweeping arrangements
- if the loan is intended to be made available for a longer period but timing is uncertain, the accounting should be based on management's best estimate of future cash flows. The accounting should be based on discounting to present value on initial recognition, based on market discount rates and estimated cash flows.

Earnings per share - what has changed

Earnings amount: basic and diluted EPS

AASB 133.9 and 30 require EPS amounts to be calculated for profit or loss attributable to ordinary equity holders of the parent entity, and if presented, profit or loss from continuing operations attributable to those equity holders. AASB 1027.5.1 and 14.1 require that EPS amounts be calculated for net profit or loss.

Shares to be included in the weighted average number of shares calculation for basic EPS

AASB 133.21 and AASB 1027.6.1.3, 6.1.5 and 6.1.6 comment on the inclusion of shares in the weighted average number of shares calculation for basic EPS. AASB 133.21 comments that in most cases, shares are included in the weighted average number of shares from the date that consideration is receivable (which is generally the date of their issue), and includes examples not provided in AASB 1027, namely:

- where ordinary shares are issued for the rendering of services to the entity
- where ordinary shares are issued in exchange for cash and
- where ordinary shares are issued in exchange for the settlement of a liability of the entity.

Contracts settled in either cash or shares

AASB 1027 does not specifically deal with contracts that may be settled in ordinary shares or cash. AASB 133.58 requires an entity to presume that contracts that may be settled in ordinary shares or cash at the entity's option will be settled in ordinary shares. The resulting potential ordinary shares are included in diluted EPS if the effect is dilutive.

ASIC/ASX deadlines

ASIC deadlines

ASIC has provided unlisted entities with an additional month to distribute financial reports to members and to lodge financial reports with ASIC. For example, unlisted companies that prepare AIFRS financial reports for the year ending 30 June 2006 will now have until 30 November 2006 to distribute and lodge those financial reports.

'ASIC considers this additional time to report is a balanced response to the burdens on non-disclosing entities that are adopting the new standards for the first time. The additional time doesn't compromise the objective of adopting the international accounting standards and has proper regard to the information needs of users of financial reports', ASIC's Deputy Chief Accountant, Mr Doug Niven said.

The relief is available to all unlisted entities, other than small proprietary companies reporting pursuant to a shareholder direction.

Annual general meetings

Unlisted public companies taking advantage of the additional month to report may need to extend the time to hold their annual general meetings by up to one month. Such companies will need to send an individual application under s.250P of the Act to ASIC's Information Processing Centre using ASIC Form 2501. ASIC isn't empowered to extend the time for an AGM without an application.

ASX deadlines

The ASX considered it appropriate to provide some assistance to listed companies in their transition to implementation for the first time of AIFRS. This is consistent with the approach taken in the United Kingdom and the United States.

The ASX has decided, as a once-only measure, to extend the reporting deadlines for Preliminary Final reports in which AIFRS are adopted for the first time. The amendment is to extend the time for lodgement of the Appendix 4E (preliminary final report) to 75 days after the period end, for first-time adoption of AIFRS (i.e. 13 September 2006 for June 30 year ends).

For further information on any of the articles in this issue of **fasttrack** contact your local Grant Thornton office.

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Adelaide

67 Greenhill Road
Wayville SA 5034
T 08 8372 6666
F 08 8372 6677
E info@gtsa.com.au

Brisbane

Grant Thornton House
102 Adelaide Street
Brisbane QLD 4000
T 07 3222 0200
F 07 3222 0444
E info@gtqld.com.au

Melbourne

Rialto Towers
525 Collins Street
Melbourne VIC 3000
T 03 9611 6611
F 03 9611 6666
E info@gtvic.com.au

Sydney

383 Kent Street
Sydney NSW 2000
T 02 8297 2400
F 02 9299 4445
E info@gtnew.com.au

Perth

256 St George's Terrace
Perth WA 6000
T 08 9481 1448
F 08 9481 0152
E info@gtwa.com.au