Testing Assets for Impairment: What level?

Points of reference for preparers of financial reports

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Introduction

Consistent confusion exists as it relates to testing assets for impairment when required by AASB 136 Impairment of Assets, particularly when identifying a cash-generating unit (CGU) in which an asset should be allocated and impairment tested. CGUs play a critical role in applying AASB 136 and, for entities that are required to complete testing for impairment, are a critical part of any assessment prepared.

While in certain situations the identification of CGUs may be self-evident, there is often a level of complexity introduced – especially where assessments were not completed correctly in an historical setting and increased scrutiny from auditors and regulators requires judgements to be revisited and/or more fully documented.

The importance of CGUs to impairment testing

AASB 136 states that, when impairment testing is required, an asset must be tested for impairment at one of the following levels:

- the individual asset;
- the CGU;
- a group of CGUs (CGU Group); or
- the Entity level.

The level at which testing is appropriate is dependent upon the facts and circumstances of the individual asset – and thus the identification of CGUs at the correct level is vital in order to apply the standard as intended.

Assets must be reviewed for impairment at the lowest level possible –this may be the individual asset but often assets must be allocated to a cash generating unit (CGU) for impairment review purposes. Further, goodwill and corporate assets will need to be allocated to a CGU or groups of CGUs – for corporate assets, this may result in certain assets being tested at the Entity level.

Some of the example indicators of impairment identified in AASB 136 relate to individual assets while others relate to larger groupings of assets, such as a CGU.

The language used by AASB 136 in examples may not provide guidance on the appropriate level to test an asset such as Goodwill.

Asset allocation

If:	Asset generates independent cash inflows or FVLCD > carrying value
Then:	FVLCD > carrying value
Otherwise:	Allocate to a CGU

When possible, assets should be tested for impairment at the individual asset level. This will be possible only when:

- the asset generates cash inflows that are largely independent of those from other assets or groups of assets);
- the asset's Fair Value Less Costs of Disposal (FVLCD) is higher than its carrying amount; or
- the asset's value in use (VIU) can be estimated to be close to FVLCD and FVLCD can be measured (AASB 136.22 and 67).

"Fair Value" is defined in AASB 13 *Fair Value Measurement* and falls outside the scope of this document.

Where this is not possible, the asset is allocated to a CGU and tested at that level. Goodwill and corporate assets do not generate cash inflows on their own and therefore, must be allocated to a CGU or groups of CGUs for impairment testing purposes.

Identifying an entity's CGUs

The standard acknowledges that identification of CGUs involves judgement. If the recoverable amount cannot be determined for an individual asset, an entity identifies the lowest aggregation of assets that generate largely independent cash inflows (AASB 136.68).

For Goodwill and certain categories of intangible assets it is typical for the assets subject to the impairment analysis to not generate their own cash inflows and thus require assessment at the CGU level – an example of a cash generating asset is included in Example 1, below.

1. Identifying largely independent cash inflows

AASB 136's guidance on whether recoverable amount can be determined for an individual asset specifically refers to cash inflows, not net cash flows or cash outflows. Accordingly, if an asset's cash inflows are largely independent but some of the related costs are interdependent with other assets, recoverable amount must still be determined at the individual asset level. This pattern continues as assets are grouped – until the asset group identified generates the required largely independent cash inflows.

A CGU thus serves two primary roles in the impairment review. It facilitates the testing of:

- assets for which the recoverable amount cannot be determined individually; and
- goodwill and corporate assets for impairment.

CGUs are required to be identified at the lowest level to minimise the possibility that impairments of one asset or group will be masked by a high-performing asset.

To identify a CGU, an entity asks two questions:

1. Does a group of assets generate largely independent cash inflows?
2. Is there an active market for the output?

AASB 136 excludes cash outflows – or costs incurred – when determining the existence of a CGU.

While monitoring by management may assist in identifying CGUs, it does not override the requirement that the identification must be based on the lowest level at which largely independent cash inflows can be identified.

Example 1: Cash generating assets

Background

A television network owns 50 TV programmes of which 20 were purchased and 30 were self-created. The network recognises each purchased programme as an intangible asset at the price paid while it expenses the cost of developing new and maintaining old programmes as incurred. Cash inflows are generated from licensing of broadcasting rights to other networks and advertising sales and are identifiable for each programme. The network manages programmes by customer segments. Programmes within the same customer segment affect to some extent the level of advertising income generated by other programmes in the segment. Management often abandons older programmes before the end of their economic lives to replace them with newer programmes targeted to the same customer segment.

Analysis

In this case, the cash inflows from each TV programme are largely independent. Even though the level of licensing and advertising income for a programme is influenced by the other programmes in the customer segment, cash inflows are identifiable for each individual programme. In addition, although programmes are managed by customer segments, decisions to abandon programmes are made on an individual basis.

When individual assets do not generate assets, the entity as a whole must be divided into components from the lowest level upwards. Because the CGU definition is based on cash inflows, this process should focus on an entity's sources of revenue and how assets are utilised in generating those revenues. Management will consider various factors including how it monitors the entity's operations (such as by product lines, businesses, individual locations, districts or regional areas) or how management makes decisions about continuing or disposing of the entity's assets and operations (AASB 136.69). While monitoring by management may assist in identifying CGUs, it does not override the requirement that the identification must be based on the lowest level at which largely independent cash inflows can be identified.

Example 3: Retail

Background

Entity A owns and operates 10 supermarkets in a major city (City B), each store residing in a different neighbourhood throughout City B. Each supermarket in City B purchases its inventory through A's purchasing centre. Pricing, marketing, advertising and human resources policies (except for the hiring of each supermarket's local staff) are decided by A. Entity A also operates 50 other supermarkets in other major cities across the country.

Analysis

The supermarkets in City B probably have different customer bases as they reside in different neighbourhoods. Accordingly, although operations are managed at a corporate level by A, each supermarket generates cash inflows that are largely independent of those of other supermarkets. Therefore, it is likely that each supermarket in City B is a separate CGU.

In making its judgement about whether each supermarket is a separate CGU, Entity A might also consider if:

- management reporting monitors revenues on a supermarket-by-supermarket basis in City B; and
- how management makes decisions about continuing or closing its supermarkets (eg on a store-by-store or on a region/city basis).

Example 2: Contracts as a package

Background

A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss. There are no other customer contracts.

Analysis

Because the entity does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the five routes together. The CGU is the bus company as a whole.

2. Identifying an active market for an output

When management has identified a group of assets that generate an output, but those assets do not generate largely independent cash inflows, it needs to consider if there is an active market for the output.

For the purposes of applying AASB 136, even if part or all of the output produced by an asset (or a group of assets) is used by other units of the entity (i.e. products at an intermediate stage of a production process), this asset (or group of assets) represents a CGU if the entity could sell the output on an active market. This is because the asset (or group of assets) could generate cash inflows that would be largely independent of the cash inflows from other assets (or groups of assets) (AASB 136.71).

This is a common issue for vertically integrated businesses whereby some groups of assets do not generate independent cash inflows, only because each operation's output is used internally, rather than being sold externally. AASB 136 addresses this issue by clarifying that even if part or all of the output produced by an asset (or a group of assets) is used by other units of the entity, this asset (or group of assets) forms a separate CGU if the entity could sell the output on an active market. An active market is defined in AASB 13 'Fair Value Measurement' as 'a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis'. This may be the case for certain commodities such as oil or gold.

Example 4: Active market for outputs

Background

Entity X produces a single product (widgets) and owns production plants 1, 2 and 3. Each plant is located in a different region of the world.

Plant 1 produces a component of the widgets that is assembled in either plant 2 or plant 3 and sold worldwide from either plant 2 or plant 3. Neither plant 2 nor plant 3 is operating at full capacity. The utilisation levels depend on the allocation of order fulfilment between the two locations.

Scenario 1: There is an active market for plant 1's component.

Scenario 2: There is no active market for plant 1's component.

Analysis: Scenario 1

Scenario 1: It is likely that plant 1 is a separate CGU because there is an active market for its output. As cash inflows for plants 2 and 3 depend on the allocation of production across the two locations, it is unlikely that the future cash inflows for plants 2 and 3 can be determined individually so they would probably be combined into a single CGU.

In determining the VIU of plants 1, 2 and 3, Entity X will adjust its financial budgets/forecasts to reflect its best estimate of future prices that could be achieved in arm's length transactions for plant 1's output while also incorporating future cash outflows used to determine the VIU of other assets impacted by the internal transfer pricing.

Analysis: Scenario 2

It is likely that the three plants (1, 2 and 3) are a single CGU because:

- there is no active market for plant 1's output and its cash inflows depend on sales of the final product by plants 2 and 3
- cash inflows for plants 2 and 3 depend on the allocation of production across the two locations. It is unlikely that the future cash inflows for plants 2 and 3 can be determined individually.

Where the cash inflows generated by an asset or CGU are affected by internal transfer pricing, an entity uses management's best estimate of future prices that could be achieved in an arm's length transaction in estimating:

- the future cash inflows used to determine the asset's or CGU's VIU; and
- the future cash outflows used to determine the VIU of any other assets or CGUs that are affected by the internal transfer pricing (AASB 136.70).

When the group of assets does not generate cash inflows that are largely independent and there is no active market for its output (even if used internally), the group is not a CGU. Management then combines these assets with others that contribute to the same revenue stream until a CGU is identified.

Override of the lowest-independent-cash flow rule – abandoned, stood-down or soon-to-be-replaced assets

If the entity determines that the asset in question does not generate cash inflows that are largely independent of those from other assets, it should assess if the asset's VIU can be estimated to be close to FVLCD and FVLCD can be measured.

The VIU of an asset may be assessed as close to or less than FVLCD when the asset is no longer in use, or soon to be replaced or abandoned, such that the estimated future cash flows from continuing use of the asset are negligible (e.g. where an entity holds a brand solely for defensive purposes).

Further, VIU may be assessed to be close to FVLCD in the limited circumstances when the entity's estimated cash flows from using the asset are consistent with the cash flows market participants would expect to generate, and costs of disposal are not material (i.e. when there are no entity-specific advantages or disadvantages, including tax-related factors).

When VIU can be estimated to be close to FVLCD, the entity will determine the recoverable amount for the individual asset (not the CGU) and any impairment is recognised immediately at the individual asset level.

Finally, when there is no reason to believe that VIU materially exceeds FVLCD, AASB 136 allows an entity to estimate FVLCD only for purposes of determining the recoverable amount (AASB 136.21).

Level of monitoring

AASB 136 includes a commonly misunderstood and misapplied requirement. Paragraph 80 requires that goodwill be tested at "the lowest level within the entity at which the goodwill is monitored for internal management purposes". This is misapplied to be a balance sheet approach – i.e. "at the level at which goodwill is posted".

This conflicts with the generally accepted view which is that goodwill is monitored "at the lowest level at which the *benefit of* the goodwill is monitored". This is generally accepted to be the level at which cash inflows are measured and monitored.

Practical insight – Structure of the impairment review

Most assets generate cash inflows only in combination with other assets as part of a larger CGU. It is not possible to calculate a recoverable amount for most individual assets that are held for continuing use. Management must then identify the CGU to which an asset belongs to determine if quantitative impairment testing is required.

Example 5: Comparison of VIU to FVLCD

Background

A mining entity owns a private railway to support its mining activities. The private railway does not generate cash inflows that are largely independent of the cash inflows from other assets of the mine. The costs of disposal of the private railway are expected to be high.

Analysis

It is not possible to estimate the recoverable amount of the private railway on a standalone basis because its VIU cannot be determined standalone and is probably different from the amount it would receive on disposal (in part due to the high costs associated with disposal). Therefore, the entity estimates the recoverable amount of the CGU to which the private railway belongs, which could be the mine as a whole.

Goodwill is not monitored at the level it is posted in the balance sheet, but the level at which decisions are made about investments in operations.

Typically, this is the level at which revenue is able to be identified at – for instance, a retail location.

Changes in cash-generating units

CGUs are identified consistently from period to period for the same asset or types of assets (AASB 136.72). If a change in CGUs is justified (eg an asset belongs to a different CGU than in previous periods or previously recognised CGUs are combined or subdivided), and an impairment loss is recognised or reversed for the CGU, the entity must disclose additional information in accordance with AASB 136.130 (AASB 136.73).

Facts and circumstances

AAS 136 does not provide examples of events or circumstances that would justify a change in CGUs. Such a change would generally be appropriate only if there has been a change in the entity's operations – i.e. different revenue-generating activities or different utilisation of assets in undertaking those activities. Typical triggers for a change might include:

- business combinations or divestments;
- restructurings;
- introduction or withdrawal of products or services; or
- entry to or exit from new markets or regions.

Gradual drift

The factors that justify a change in CGU structure sometimes develop over time rather than being driven by a specific event. For example, an entity might gradually change the way it allocates order intake across its production facilities or how it utilises assets to generate a revenue stream. In our view, the change in CGU structure is justified if an asset's cash inflows become, or cease to be, independent even if this cannot be attributed to a specific event. One practical suggestion for determining the effective date of the change is to consider when management began reviewing or assessing the CGUs differently (e.g. when management reporting changed).

Allocate assets to the cash generating units

After the entity identifies its (new) CGUs it must determine which assets belong to which CGUs, or groups of CGUs. The basis of allocation differs for:

- operational assets;
- corporate assets; and
- goodwill.
- The basis of allocation is discussed in detail in the section "Allocation of assets to CGUs".

Operational assets and Corporate assets

Operational assets

Operational assets are those that are directly utilised in the generation of cash inflows – either as the asset, group of assets, or CGU level. Examples include, but are not limited to:

- Machinery used in manufacturing;
- Shelving in warehouses;
- Trucks used by a logistics company.

Corporate assets

Management may identify certain assets that contribute to the estimated future cash flows of more than one CGU – these are Corporate assets (sometimes referred to as 'shared assets'). A distinctive characteristic of a corporate asset is that it does not generate cash inflows independently of other assets or groups of assets and its carrying amount cannot be fully attributed to the CGU under review (AASB 136.100).

Examples include, but are not limited to:

- a headquarters building
- shared IT equipment
- a research centre
- corporate or global brands.

Allocation of assets to CGUs

After the entity has identified its CGUs, it must allocate its assets (and liabilities) to CGUs or, in certain instances, groups of CGUs. This basis of allocation differs for each class of asset – Operational assets and Corporate assets, as described above, and Goodwill (right).

Assets that are tested for impairment on an individual basis are required to be included in a CGU where appropriate – net of any impairment recognised.

Operational assets

Operational assets are allocated to a CGU based on the CGU in which it assists in the generation of independent cash inflows, but, as identified above, may also be subject to impairment testing at the individual asset level.

Goodwill

Goodwill may be subject to testing at either the CGU or Group of CGUs level – not at the Corporate level. As Goodwill does not generate its own independent cash inflows, it cannot be tested for impairment at the Asset level.

Corporate assets

Corporate assets are tested at the lowest level at which they can be allocated in a non-arbitrary manner. If there is an indication of impairment for the corporate asset itself, recoverable amount cannot be determined at the individual asset level, unless management has decided to dispose of it (because corporate assets do not generate separate cash inflows) (AASB 136.101).

Generally

Except for Goodwill, assets are allocated for testing starting from the Asset level until a level is identified at which the benefit of the asset is wholly received. For some (shared) assets, this may be at a level higher than the CGU (e.g. a warehouse).

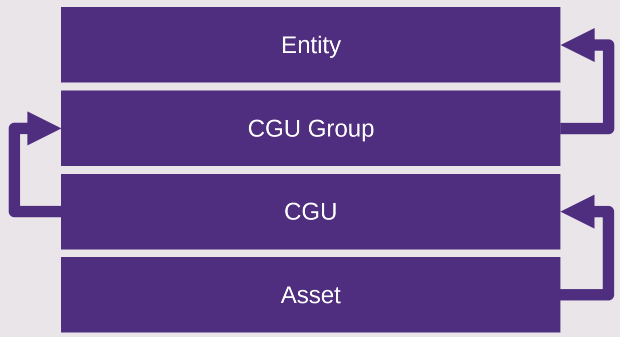
Allocation of Goodwill

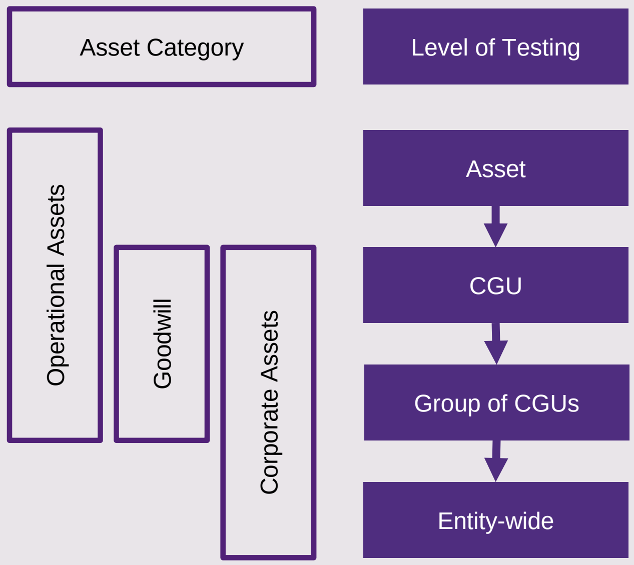
Goodwill is unique in that it is not a 'single' asset but a collection of 'other' assets that do not qualify for recognition. As a result, the value of Goodwill is not allocated to a single CGU, but to each CGU or Group of CGUs that will benefit from the Goodwill acquired.

Goodwill

Goodwill is defined by AASB 3 *Business Combinations* and represents those intangible assets that are not identifiable and recognisable by the entity. Generally, it represents the economic benefit of these unrecognisable assets and, as a result, cannot generate its own cash inflows.

Asset allocation





This can result in the acquisition of a business (that is a single new CGU) impacting Goodwill at multiple levels.

This allocation of Goodwill is made on a relative-benefit basis – that is, Goodwill is allocated to where the improvement in cash flow will be experienced.

AASB 136.80(b) limits the largest level at which Goodwill can be allocated – the operating segment, as defined by paragraph 5 of AASB 8 Operating Segments. This is the level reached prior to aggregation into reporting segments, as included in segment disclosures as defined by AASB 8.

Example 6: Allocation of Goodwill and other assets

Background

An entity owns 10 retail sites, a distribution business, and a service provision business. There are twelve CGUs. The distribution business and service provision business sell via the retail sites in addition to their external customers. The entity acquires 10 more retail sites which will drive additional distribution and service provision cash inflows. New volume discounts are now available to the 20 retail sites that were previously unavailable. As a part of the acquisition, an IT system was acquired that will be used across all retail locations. Administration costs will not increase after the acquisition. Marketing for the retail sites will also not alter.

Analysis

The IT system is allocated to the Group of CGUs that comprise the 20 retail sites. Goodwill is allocated to all 22 CGUs based on a systematic approach – AASB 136 is silent on the preferred method, however the entity may determine that the appropriate approach to allocate goodwill is based on the relative increase in value of each CGU when measured separately and then in conjunction with the newly acquired business. Goodwill will also be allocable to the Group of CGUs comprising the 20 retail locations, representing benefits from reduced per-site marketing costs – costs not incurred by the retail sites, but from which the retail sites benefit in aggregate.

The entity as a whole does not have goodwill allocated as there were no cost savings that occurred.

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Please note that the examples in this document are based on those included in AASB 136 *Impairment of Assets.*