Deloitte.

A Closer Look

IAS 36 Impairment of non-financial assets – reminders and hot topics

Contents

What to test for impairment loss under IAS 36 and when

How to determine recoverable amount

Other issues

Further guidance

With many entities experiencing a variety of effects arising from broader macroeconomic uncertainty, the requirements of IAS 36 *Impairment of Assets* will merit careful consideration by many. Regulators, such as the European Securities and Markets Authority, have also recently issued reminders of key considerations on this topic.

In the UK, the Financial Reporting Council (FRC) noted as part of its *Key matters for 2022/23 reports and accounts* that at times of increased uncertainty the measurement of asset impairments may pose challenges. Its *Annual Review of Corporate Reporting 2021/2022* also identified areas for improvements regarding the application of IAS 36 as did the 2019 thematic review it undertook on impairment of non-financial assets.

This publication answers some common questions on applying the Standard, addressing potential pitfalls and providing reminders of certain key requirements of IAS 36. It is not however a comprehensive guide to the application of IAS 36. Links to the questions this publication addresses are set out below:

What to test for impairment loss under IAS 36 and when

- What assets are subject to the requirements of IAS 36?
- When should these assets be tested for impairment?
- Are impairment tests required for the purpose of interim reporting?
- At what level should the impairment test be performed?
- How are cash-generating units identified?
- Is there a specific order in which assets and CGUs should be tested?
- What about reversals of impairment losses?

How to determine recoverable amount

- What is recoverable amount?
- What is the impact of forecast maintenance, asset enhancements and restructurings on value in use?
- Over what period should cash flow forecasts be based on budgets and forecasts?
- How are corporate assets and corporate costs incorporated into value in use?
- How should climate change considerations be incorporated?
- How should parent entities test investments in subsidiaries and other entities for impairment?

Other issues

- How are impairment losses allocated to the assets of a CGU?
- What are the sensitivity analysis disclosures required by IAS 36 and IAS 1?

What to test for impairment loss under IAS 36 and when

What assets are subject to the requirements of IAS 36?

IAS 36 has a relatively broad scope and applies to (among other assets):

- Land, buildings, and machinery and equipment carried at cost or revalued amounts;
- Right-of-use assets arising under leases
- Investment property carried at cost
- Biological assets carried at cost
- Intangible assets carried at cost or revalued amounts
- Goodwill
- Investments in associates and joint ventures in consolidated financial statements
- Investments in subsidiaries, associates and joint ventures in separate financial statements (other than those accounted for in accordance with IFRS 9 *Financial Instruments*)

IAS 36 itself sets out its scope by stating that it applies to all assets other than a list of exceptions. Certain notable exceptions are inventories, deferred tax assets and financial assets within the scope of IFRS 9.

When should these assets be tested for impairment?

Irrespective of whether there is any indication of impairment, the following items are required to be tested for impairment at least annually:

- Intangible assets with an indefinite useful life
- Intangible assets that are not yet available for use
- Goodwill

The mandatory annual test may be performed at any time during the annual period, provided that it is performed at the same time every year. When goodwill was acquired in a business combination during the current annual period, or one of the intangible assets requiring annual testing was initially recognised during the period, that must be tested for impairment before the end of the current annual period.

Furthermore, an entity should assess at the end of each reporting period (including interim reporting dates) whether there is any indication that an asset (within scope of IAS 36) may be impaired. If any such indication exists, the entity should estimate the recoverable amount of the asset.
In assessing whether there is any indication that an asset may be impaired IAS 36 requires consideration of several indicators, considering both internal and external sources of information.

An entity would also be required to assess whether there is an indication of impairment when an asset is taken out of use to be sold (or distributed to owners). If the asset qualifies as held for sale, in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, it will be measured applying that Standard and will cease being subject to the requirements of IAS 36. However, immediately before this reclassification, IFRS 5:18 requires the asset to be measured in accordance with the Standard generally applicable to the asset. Hence, if there is an indication that an asset generally subject to IAS 36 may be impaired immediately before its reclassification as held for sale, the entity would test the asset for impairment applying IAS 36. Any resulting impairment loss would be reported separately as such.

For the purpose of its consolidated financial statements, an entity should consider the specific indicators of impairment in IAS 28 *Investments in Associates and Joint Ventures* paragraphs 28:41A-41C in respect of its investments in associates and joint ventures.

Except in the case of the mandatory annual tests mentioned above, IAS 36:15 notes that an entity would apply the concept of materiality to determine whether the recoverable amount of an asset needs to be estimated. For example, if a previous test demonstrates that the recoverable amount of a CGU is significantly greater than its carrying amount, the entity may not need to re-estimate the CGU's recoverable amount if no events have occurred that would eliminate that difference. This may also be the case if a previous analysis shows that a CGU's recoverable amount is not sensitive to one (or more) of the indications listed in IAS 36.

Hot topic - Potential indication of impairment – increased market interest rates

Whilst IAS 36 identifies an increase in market interest rates as an indication that an asset may be impaired, it also notes that in some cases an entity may not be required to make a formal estimate of the asset's recoverable amount despite such increases. This may be the case if the increase in market interest rates does not affect the appropriate discount rate for the asset in question (for example, if short-term interest fluctuations would not affect the discount rate used for a longer-life asset) or if the entity expects to recover higher interest charges through prices charged to its customers, or the interest rate increase is too small to raise concerns over the headroom of an asset's recoverable amount over its carrying amount. However, the possibility of an impairment loss should not be overlooked and a general increase in interest rates should lead to a proper consideration of whether a full impairment review is required.

Are impairment tests required for the purpose of interim reporting?

IAS 34 *Interim Financial Reporting* requires that an entity should apply the same impairment testing, recognition and reversal criteria at an interim date as it would at the end of its financial year. However, an entity would not necessarily make a detailed impairment calculation at the end of each interim period. Instead, it may be sufficient for the entity to perform a review for indications of significant impairment or reversals of impairment since the end of the most recent financial year to determine whether such a calculation is needed.

When an entity recognised an impairment loss relating to an asset at the end of the preceding financial year, a review of the impairment calculations at the end of the interim period may be necessary if the impairment indicator that gave rise to the impairment review is still present.

When an impairment test was performed at an interim reporting date it will still be necessary to consider whether further indicators of impairment or indicators for reversals of impairment of assets other than goodwill have arisen at subsequent reporting dates.

It should be noted that while one of the key principles in IAS 34 is that the frequency of an entity's reporting (annual, half-yearly or quarterly) should not affect the measurement of its annual results, the notable exception to this principle is the recognition of impairment losses on goodwill, as addressed in IFRIC 10 *Interim Financial Reporting and Impairment.* As explained in IFRIC 10, if an impairment test is performed in an interim period and results in the write-down of goodwill, the impairment loss must be recognised in the interim financial report and this impairment loss cannot be reversed in a subsequent period. This is the case even if matters improve in a subsequent interim period or by the end of the entity's financial year such that if the test was performed at the later date, the impairment loss on goodwill may be lower or may not exist.

At what level should the impairment test be performed?
It is important to ensure that the impairment test is conducted at the right 'level'. Depending on facts and circumstances this level may be an individual asset, a group of assets, known as cash-generating units (CGUs), or a group of CGUs.

Indeed, IAS 36:22 requires that the recoverable amount (see What is recoverable amount?) is determined at the individual asset level, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the CGU to which the asset belong unless either:

- The asset's fair value less costs of disposal is higher than its carrying amount
- The asset's value in use can be estimated to be close to its fair value less costs of disposal and fair value less costs of disposal can be measured

Goodwill by its nature cannot be tested for impairment as an individual asset. Rather, goodwill acquired in a business combination is, from the acquisition date, allocated to each of the acquirer's CGUs, or groups of CGUs, that are expected to benefit from the synergies of the combination. IAS 36 specifies that goodwill should not be allocated to a group of CGUs larger than an operating segment, as defined by paragraph 5 of IFRS 8 *Operating Segments*, before aggregation. This requirement applies irrespective of whether an entity is subject to the disclosure requirements in IFRS 8.

How are cash-generating units identified?
A CGU is 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.

For entities operating in multiple locations that generate cash inflows in the same (or a similar) manner, an individual location will constitute a single CGU if its cash inflows are independent from those of other locations. However, there may be evidence of a significant degree of interdependence between the cash inflows from each location resulting from revenue substitution between those locations (i.e. there is evidence that a decrease in cash inflows in one location is accompanied by an increase in cash inflows from one or more other locations). In such circumstances, it may be determined that the appropriate CGU comprises a group of two or more locations.

It is important to distinguish between interdependence of cash inflows from different locations operated by an entity and common dependence of the different locations on an external factor (e.g. commodity prices) or an asset (e.g. a brand). In addition, interdependence of cash outflows (resulting from, for example, a centralised purchasing function or shared management costs) is not relevant to the identification of CGUs.

If an active market exists for the output produced by an asset or a group of assets, it should be identified as a CGU, even if some or all of the output is used internally. This is because this asset or group of assets *could* generate cash inflows that would be largely independent of the cash flows from other assets or groups of assets. In such cases, management estimates the expected market price for the output of the CGU and uses that estimate not only when determining the value in use of the supplying CGU, but also when determining the value in use of the other CGU that is using the output. In other words, market prices rather than internal transfer prices are used when estimating the recoverable amount of a CGU.

An entity's internal management reporting is relevant to the identification of CGUs insofar as it provides evidence regarding the independence (or interdependence) of cash inflows generated by assets or groups of assets (including, cash flows generated in different locations in which an entity operates). However, internal management reporting is not a determinative factor in its own right and should not override other evidence that demonstrates that cash inflows from an asset or a group of assets are indeed independent.

Is there a specific order in which assets and CGUs should be tested?
If goodwill is allocated to an individual CGU and there is an indication that one of the assets in the CGU is impaired and if it is capable of being tested in isolation for impairment (see At what level should the impairment test be performed), the asset should be tested for impairment before the CGU to which goodwill is allocated is tested.

Similarly, when goodwill has been allocated to a group of CGUs, and there is an indication that an individual CGU within the group is impaired, the individual CGU is tested for impairment first (and any identified impairment loss relating to the individual CGU recognised) before testing for impairment the group of CGUs to which goodwill has been allocated.

What about reversals of impairment losses?

When an impairment loss was recognised for an asset other than goodwill or for a CGU in a prior period, an entity is required to assess at the end of each reporting period whether there is any indication that the impairment loss may no longer exist or may have decreased. If such an indication exists, the entity should estimate the recoverable amount of that asset (or CGU) to determine if all or part of the previously recognised impairment loss should be reversed. However, an impairment loss recognised in respect of goodwill cannot be reversed.

A reversal of an impairment loss must reflect an increase in the estimated service potential of an asset (or CGU), either from use or sale. Examples of such changes include:

- A change in the basis for recoverable amount (i.e. whether recoverable amount is based on fair value less costs of disposal or value in use)
- If recoverable amount was based on value in use, a change in the amount or timing of estimated future cash flows or in the discount rate
- If recoverable amount was based on fair value less costs of disposal, a change in estimate of the components of fair value less costs of disposal.

An increase in the recoverable amount of the asset due to the passage of time does not, however, represent an increase in the estimated service potential of an asset and, therefore, it is not acceptable to recognise a reversal of an impairment loss on this basis. In other words, the value in use of an asset may increase and even become greater than the carrying amount of the asset simply because the present value of future cash inflows increases as they become closer (i.e. 'the discount unwinds'). This does not, however, represent an economic change in the value of the asset. Therefore, a reversal of an impairment loss should not be recognised on this basis. Nevertheless, if an impairment reversal is recognised due to a change in assumptions the reversal should be recognised in full and not split between amounts relating to a change in assumptions and amounts relating to the unwind of the discount.

It is worth noting that an impairment loss can only be reversed to the extent that it does not increase the carrying amount of the related asset(s) above what it would have been had the impairment loss never been recognised.

How to determine recoverable amount

What is recoverable amount?

The recoverable amount of an asset (or a CGU or a group of CGUs) is the higher of its fair value less costs of disposal and its value in use. If the carrying amount of the asset exceeds its recoverable amount, an impairment loss is recognised to reduce the carrying amount.

It is important that a CGU's recoverable amount, whether based on fair value less costs of disposal or value in use, is determined on a basis consistent with its carrying amount i.e. it reflects those assets allocated to the CGU. For example, the carrying amount of a CGU does not include the carrying amount of any recognised liability, unless the recoverable amount of the CGU cannot be determined without consideration of this liability. Accordingly, the cash flows associated with liabilities excluded from a CGU's carrying amount are also excluded from recoverable amount.

The fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Value in use is the present value of the future cash flows expected to be derived from an asset or a CGU.

The discount rate used to determine the present value should be a pre-tax rate that reflects the risks specific to the asset or CGU being tested for which future cash flow estimates have not already been adjusted. Accordingly, discount rates used for the various CGUs within a group may vary depending on the geographies or industries in which the CGUs operate. Discount rates should reflect a market participant rate, rather than the cost of financing internal to the entity. Finally, entities should also ensure that the inputs used in determining value in use follow a consistent approach in incorporating the effects of inflation. Nominal cash flows, which include the effect of inflation, should be discounted at a nominal rate and real cash flows, which exclude the effect of inflation, should be discounted at a real rate.

For the purposes of an impairment review, it is not always necessary to calculate both fair value less costs of disposal and value in use:

- If either the fair value less costs of disposal or the value in use is found to be higher than the carrying amount, the asset is not impaired, and there is no need to calculate the other amount
- If there is no basis for making a reliable estimate of fair value less costs of disposal, recoverable amount is measured by reference to value in use alone

- The detailed calculations involved in measuring value in use may be avoided if a simple estimate is sufficient to show either that value in use is higher than the carrying amount (in which case there is no impairment) or that it is lower than fair value less costs of disposal (in which case recoverable amount is the fair value less costs of disposal).

Although some entities may have historically concluded that recoverable amount has consistently been value in use (or fair value less costs of disposal), it is important that entities remember recoverable amount is the higher of value in use and fair value less costs of disposal, acknowledging that, as set out above, it may not always be necessary to determine both.

What is the impact of expected maintenance, asset enhancements and restructurings on value in use?

When determining value in use, forecasts of cash flows should exclude the impact of improving and enhancing assets. They should, however, include future cash flows necessary to maintain the level of economic benefits expected to arise from the asset in its current condition, for example overhauls or fault inspections. In practice it may not be easy to distinguish between maintenance and improvements.

For the purchase of replacement assets to be considered maintenance expenditure, and therefore included in a value in use calculation, it is not necessary for forecast replacement assets to be identical to those currently in use. For example, if an asset forming part of a CGU is expected to be replaced by an asset that does not significantly change the manner of operations, but instead is a technological upgrade fulfilling the same function then, unless that replacement enhances the economic output of the CGU, the expenditure on the replacement (and resultant continuation of cash inflows) should be included in a value in use calculation.

Value in use does not reflect future cash outflows and related cost savings (for example reductions in staff costs) or benefits that are expected to arise from a future restructuring to which an entity is not yet committed. IAS 36 defines a restructuring in the same way as IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, as "a programme that is planned and controlled by management and materially changes either the scope of a business undertaken by an entity or the manner in which that business is conducted."

Determining whether a change in operations is material will require the application of judgement. In applying that judgement, it will often be necessary to consider whether either:

- The output from an asset or CGU or the process of producing that output will change significantly (indicating a material change that is excluded until the entity is committed to a restructuring)
- Whether the change is a refinement to that output or process (indicating that the change does not meet the definition of a restructuring)

Example - Refinement of a manufacturing process included in value in use calculation

Entity B is testing a CGU consisting of a facility manufacturing disposable coffee cups for impairment. In response to consumer pressure, Entity B plans to replace an element of the manufacturing process with one that makes the cups produced more easily recyclable.

Management's judgement is that this will not lead to a major change of the disposable coffee cups which are sold, or of their production, and therefore, that it just constitutes a refinement of the manufacturing process, rather than a material change to the facility's operations or output. Accordingly, the cost of the alteration to that element of the manufacturing process and its effect of maintaining revenues that would otherwise be lost to Entity B's competitors are included in the calculation of the CGU's value in use.

Over what period should cash flow forecasts be based on budgets and forecasts?

Forecasts are used in a variety of accounting estimates, including, but not limited to, those related to the assessment of goodwill and other non-financial assets for impairment, expected credit losses assessments, recoverability of deferred tax assets, liquidity analysis and the appropriateness of the going concern presumption. Consistent assumptions should be used, noting that key differences may be justified and expected when they reflect the differences in the objectives and requirements of other financial statements estimates. Entities must ensure that assumptions are consistent with external sources of information as well as with their climate strategy and any public commitments made in that respect.

When determining value in use, cash flow projections should be based on the most recent financial budgets/forecasts that have been approved by management. Projections based on these budgets/forecasts should cover a maximum period of five years, unless a longer period can be justified.

Detailed budgets/forecasts for a period of greater than five years are generally not available and, if they are available, are less likely to be accurate. However, if management has produced budgets/forecasts for a period greater than five years and can demonstrate, based on past experience, that its forecasting methods are reliable for such extended periods, it can use forecasts for periods exceeding five years if it is confident that these projections are reliable. This is expected to be very much the exception, not the rule.

Projections of cash flows beyond the period covered by the most recent budgets/forecasts should be estimated 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 based on objective information about patterns over a product or industry lifecycle. This growth rate should not be overly optimistic and should 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. In some cases, it may be appropriate for the growth rate to be zero or negative.

In extrapolating the final year covered by budgets/forecasts it is important to ensure that it is appropriately representative of the longer term. Depending on the circumstances it may also be necessary to make additional adjustments to capture items such as capital expenditure towards replacement assets and lease renewals arising after that final year covered by budgets or forecasts. Adjustments may also be needed to reflect the potential impacts of climate-change.

Hot topic - How should climate change considerations be incorporated?

A growing number of scientific projections detail not only potential average increases in global temperatures, but also how such changes will translate into physical phenomena such as rising sea levels and more frequent extreme weather events. Economic forecasts are also increasingly reflecting the impact of such changes, together with related factors such as carbon pricing initiatives and changing demand for fossil fuels and renewable energy.

As highlighted by organisations including the Intergovernmental Panel on Climate Change (IPCC) and the World Economic Forum (WEF), this could result in various effects (positive or negative) on business models across all industries. This is due to the physical effects of climate change and to related effects on regulation, technological developments and consumer preferences. Changes in market expectations and reputational risk might also result in entities choosing to amend their business models.

These factors may result in changes to management's cash flow projections (based on reasonable and supportable assumptions that represent management's best estimate of economic conditions as required by IAS 36:33(a)), or the level of risk associated with achieving those cash flows, in which case they should, as appropriate, form part of an entity's value in use assessment. When climate change is discussed in an entity's broader corporate reporting (for example, in terms of risks to which the entity is exposed or changes to its business model), consideration should be given to whether any changes referred to have been appropriately considered as part of the entity's impairment testing.

Changes in consumer behaviour are not dependent on any restructuring by the entity or change to the asset or CGU itself. As a result, management's best estimate of any forecast changes in consumer behaviour expected to result in changes (positive or negative) in either the volume or price of future sales should be included in the determination of the recoverable amount of the asset or CGU.

The same approach should be applied to expected changes in the behaviour of an entity's suppliers or business customers, who may themselves react to changing expectations of society, resulting in changes to an entity's cost base or revenues to the extent the estimates are based on reasonable and supportable assumptions.

Prior to enacting detailed legislation, a government might set a target to achieve net zero emissions within a certain timescale demonstrating an intent to pass legislation in the future. If expected government action would affect the cash flows generated by an asset or CGU, it will be necessary to consider at what point this should be factored into cash flow forecasts.

Judgement will be required in determining when expected government action affects cash flow projections. However, unlike for the recognition of a new liability under either IAS 12 *Income Taxes* or IFRIC 21 *Levies*, it is not necessary to wait for the enactment or substantive enactment of a change before it is incorporated into an estimate of future cash flows supporting the carrying amount of an existing asset or CGU. Management's best estimate may be that, whilst the exact nature or form of the government legislative or regulatory action is not certain, there will nonetheless be an effect on the entity's future cash flows. If this is the case, the expected changes in cash flows should be included in a value in use calculation, as long as they are based on reasonable and supportable assumptions.

When climate-related factors are a significant factor in determining the recoverable amount of CGUs containing significant goodwill or intangible assets with indefinite useful lives, the key assumptions applied together with a description of management's approach to determining the value assigned to each key assumption should be disclosed in accordance with IAS 36. When relevant, this disclosure should provide an explanation of not only the key assumption, but also of its forecast effects on the entity's future cash flows.

As explained below , disclosure of a key source of estimation uncertainty may also be required by IAS 1 Presentation of Financial Statements.

How are corporate assets and corporate costs incorporated into value in use?

Corporate assets are assets other than goodwill that contribute to the future cash flows of both the CGU under review and other CGUs. Such assets may include group or divisional assets such as a headquarters building or a research centre. Other examples of corporate assets may include brands and operating licences. As a result of the fact that corporate assets are not attributable to a single CGU there is an increased risk that they are incorrectly omitted from IAS 36 impairment calculations.

As part of performing an impairment test, it is important to identify the corporate asset(s) that relate to the CGU being tested. If a portion of the carrying amount of a corporate asset:

- Can be allocated on a reasonable and consistent basis to the CGU, the entity compares the carrying amount of the CGU (including the allocated portion of the carrying amount of the corporate asset) with its recoverable amount. Any impairment loss is recognised
- Cannot be allocated on a reasonable and consistent basis to that CGU, the entity:
  - compares the carrying amount of the CGU, excluding the corporate asset, with its recoverable amount, and recognises any impairment loss;
  - identifies the smallest group of CGUs that includes the CGU under review and to which a portion of the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis; and
  - compares the carrying amount of that group of CGUs, including the allocated portion of the carrying amount of the corporate asset, with the recoverable amount of the group of CGUs. Any impairment loss is recognised.

When corporate assets have been allocated to a carrying amount of a CGU, any internal charges incurred by the CGU for using such assets should not be included in the CGU's expected future cash flows. To do so would be to double-count the impact of the corporate assets and could result in an impairment loss being recognised incorrectly.

Illustrative example 8 accompanying IAS 36 illustrates the application of the requirements for corporate assets.

All corporate costs that can be directly attributed to the use of a CGU (or group of CGUs to which goodwill has been allocated), or that can be allocated on a reasonable and consistent basis to that CGU (or group of CGUs) should be included in the calculation of the value in use. This will generally be the case for costs such as IT costs, human resource costs or certain direct marketing activities.

However, there is no requirement that all corporate costs be included in management's estimate of expected future cash flows used for the calculation of the value in use of a CGU (or group of CGUs to which goodwill is allocated). Some costs may be determined to be neither directly attributable nor capable of being allocated on a reasonable and consistent basis to a CGU (or group of CGUs). Based on facts and circumstances, examples of such costs might include payments to the non-executive directors of an entity or those related to investor relations.

How should parent entities test investments in subsidiaries and other entities for impairment?

In a parent entity's separate financial statements, investments in subsidiaries, associates and joint ventures should be tested for impairment in accordance with IAS 36 (unless the investment is accounted for applying IFRS 9). IAS 36 includes as indications that such an investment could be impaired the fact that the investor recognises a dividend from the investment and there is evidence available that either:

- The carrying amount of the investment in the investor's separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or
- The dividend exceeds the total comprehensive income of the subsidiary, joint venture or associate in the period the dividend is declared.

It is also important to remember that the asset being tested for impairment is the carrying amount of the investment the parent holds, rather than the underlying assets held by the investee.

In particular, when performing an impairment test for the purposes of its consolidated financial statements, a parent entity may have determined that the activities of a subsidiary represent a CGU. For purposes of its separate financial statements, whilst the parent entity may use the recoverable amount of the CGU as a starting point to determine the recoverable amount of the investment in the subsidiary, certain adjustments may be necessary. This is the case whether the recoverable amount is determined as the value in use or fair value less costs of disposal. For example, the recoverable amount of the CGU may need to be adjusted for the effects of:

- Certain assets of the subsidiary that are outside the scope of IAS 36 but that would contribute to the recoverable amount of the parent's investment in the subsidiary, for example investment properties measured at fair value under IAS 40 Investment Property
- Certain liabilities that are typically required to be ignored when determining the recoverable amount of the CGU but that would reduce the parent's equity value of the investment in the subsidiary. These liabilities may include financial liabilities (e.g. debt) under IFRS 9, lease liabilities under IFRS 16 Leases, provisions under IAS 37 Provisions and current tax liabilities under IAS 12

In addition, if the subsidiary is not wholly-owned, an adjustment will typically be required as the recoverable amount of the CGU for the purposes of the consolidated financial statements reflects the full amount of the relevant cash flows and not solely the percentage attributable to the parent's ownership.

Depending on facts and circumstances, other adjustments may be necessary.

In its *Annual Review of Corporate Reporting 2021/2022,* the FRC noted that it wrote to companies where there were impairment indicators but no evidence of an impairment assessment having been made, for example, where the parent company's net assets exceeded market capitalisation.

Other issues

How are impairment losses allocated to the assets of a CGU?

An impairment loss should be recognised for a CGU (or the smallest group of CGUs to which goodwill or a corporate asset has been allocated) if, and only if, its recoverable amount is less than its carrying amount. The impairment loss should be allocated to reduce the carrying amount of the assets of the CGU or group of CGUs in the following order:

- First, to goodwill allocated to the CGU (group of CGUs)
- Then, to the other assets of the CGU (group of CGUs) pro rata on the basis of the carrying amount of each asset in the CGU (group of CGUs)

When allocating an impairment loss to individual assets within a CGU, the carrying amount of an individual asset should not be reduced below the highest of:

- Its fair value less costs of disposal (if measurable)
- Its value in use (if determinable)
- Zero

If this results in an amount being allocated to an asset which is less than its pro rata share of the impairment loss, the excess is allocated to the remaining assets within the CGU on a pro rata basis.

After the allocation procedures have been applied, a liability is recognised for any remaining impairment loss for a CGU if, and only if, that is required by another Standard. If it is not required by another Standard the remaining impairment loss is not recognised. A liability will only be recognised in respect of present obligations arising as a result of past events. IAS 37 describes the appropriate recognition criteria. When a provision is required to be recognised, it is measured in accordance with the general requirements of IAS 37.

Where an item of property, plant and equipment is impaired IAS 16 *Property, Plant and Equipment* requires the item's estimated useful life, depreciation method and residual value should all be reviewed and the new carrying amount depreciated over the asset's remaining useful life. IAS 38 *Intangible Assets* contains similar requirements in respect of intangible assets.

What are the sensitivity analysis disclosures required by IAS 36 and IAS 1?

IAS 36 requires specific sensitivity analysis in respect of CGUs (or group of CGUs) to which goodwill or intangible assets with indefinite useful lives have been allocated. In particular, if a reasonably possible change in a key assumption on which management has based its determination of the CGU's (or group of CGUs') recoverable amount would cause the CGU's (or group of CGUs') carrying amount to exceed its recoverable amount the following shall be disclosed:

- The amount by which the CGU's (or group of CGUs') recoverable amount exceeds its carrying amount
- The value assigned to the key assumption
- The amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the CGU's (or group of CGUs') recoverable amount to be equal to its carrying amount

These disclosures are made separately for each CGU (or group of CGUs) that have been allocated an amount of goodwill or intangible assets with indefinite useful lives that is significant in comparison to the total carrying amount of goodwill or intangible assets with an indefinite life.

If the amount of goodwill or intangible assets with indefinite useful lives allocated to individual CGUs (or group of units) is not significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, but the aggregate amount is significant and the same key assumptions have been used, the disclosures is presented on an aggregated basis.

In addition, IAS 1 requires an entity to disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In particular, an entity should disclose details of the nature of those assets and liabilities, and their carrying amount as at the end of the reporting period. IAS 1 indicates that an entity should provide the information in a manner that helps users of financial statements to understand the judgements that management makes about the future and about other sources of estimation uncertainty, for example:

- The sensitivity of the carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity
- The expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected
- An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved

The IAS 36 sensitivity disclosures provide information on circumstances where a reasonably possible change in an assumption could give rise to an impairment in respect of CGUs to which goodwill and intangible assets with indefinite useful lives have been allocated. The IAS 1 disclosures provide information on assumptions that have a significant risk of resulting in a material adjustment to the carrying amounts of any assets and liabilities within the next financial year.

Furthermore, whereas IAS 36 requires the disclosure of the amount by which the value assigned to the key assumption(s) must change in order to eliminate a CGU's (or group of CGUs') 'headroom' to nil, the information required by IAS 1 relates to the sensitivity of the carrying amounts of assets and liabilities to assumptions and the range of reasonably possible outcomes within the next financial year.

In its *Annual Review of Corporate Reporting 2021/2022*, the FRC stated that many of its queries could have been avoided by clearer disclosures to explain some of the key assumptions or inputs applied in the impairment assessments performed. It reminded companies of the guidance set out in its recent thematics on impairment of non-financial assets and the financial reporting effects of COVID-19. In addition, its thematic on discount rates includes some relevant guidance to consider when calculating discount rates and preparing impairment-related disclosures. A case study is also included, illustrating how one company improved its disclosures following review.

The FRC also reminded companies that they should ensure:

- The sensitivity of recoverable amounts to changes in assumptions is explained, particularly where the range of reasonably possible outcomes has widened under a more uncertain outlook
- The effects on the assumptions made in the impairment assessment relating to potential reduced customer demand, increased costs and other factors that affect the business in the current environment are disclosed
- Impairment reviews and/or disclosures appropriately reflect information elsewhere in the report and accounts
- The composition of CGUs and the basis for the allocation of goodwill to CGUs or groups of CGUs is adequately explained

UNDERSTANDING AN AUDITOR'S PERSPECTIVE:

ISA 540: ***Auditing Accounting Estimates and Related Disclosures*** **considerations**

Valuation of assets is an accounting estimate that falls within the scope of an audit. Adhering to the requirements of ISA 540 which addresses the auditing of accounting estimates and related disclosures is important when executing the audit.

Under ISA 540, the auditor can chose from three methods of testing the accounting estimate:

1. Test management's process
2. Develop an independent expectation
3. Obtain evidence from events occurring up to the date of the audit report

When testing an impairment review where value in use has been relied upon, the auditor will most commonly:

Test how management made the accounting estimate

Audit procedures will be designed and performed to obtain sufficient appropriate audit evidence regarding the risk of material misstatement relating to:

- The selection and application of methods, significant assumptions and data used by management when making the accounting estimate (including evaluation of the work of management's expert)
- How management selected the point estimate and developed related disclosures about estimation uncertainty

The ISA requires audit procedures to be performed to develop an understanding of the entity's internal controls over methods, significant assumptions, data and management's selection of a point estimate and related disclosures about estimation uncertainty.

Management should ensure sufficient audit evidence exists to support the methods, significant assumptions and data used, in addition to the stand back analysis that management would typically rationalise in an accounting paper.
Examples of audit evidence could include:

- Customer orders
- Sales or purchase contracts
- Evidence of costs incurred
- Detail of comparable product launches/cost saving initiatives being successfully delivered by the management team
- Independent sector research

Determine whether the accounting estimates are reasonable or misstated

When the audit evidence obtained supports a range, the size of the range may be wide, and in some circumstances, may be multiples of materiality. Although a wide range may be appropriate in the circumstances, it is important for auditors to reconsider whether sufficient appropriate audit evidence has been obtained regarding the reasonableness of the amounts within the range.

The audit evidence may support a point estimate that differs from management's point estimate. In such circumstances, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement.

The audit evidence may support a range that does not include management's point estimate. In such, circumstances, the misstatement is the difference between management's point estimate and the nearest point of the auditor's range.

It is critical that management are able to provide evidence to support each data input or significant assumptions individually as when inputs are identified as unsupportable or outside of an acceptable range, it will not be appropriate for the auditor to offset judgements in other areas against the misstatement identified. Each misstatement needs to be assessed in isolation to determine its impact on the carrying value or disclosures.

Further guidance

The Deloitte Accounting Research Tool (DART) is a comprehensive online library of accounting and financial disclosures literature.

GAAP in the UK on DART allows access to the full IFRS Standards, linking to and from:

- Deloitte's authoritative, up-to-date, GAAP manuals which provide guidance for reporting under IFRS Standards
- Model financial statements for entities reporting under IFRS Standards

In addition, our sustainability reporting volume of GAAP provides guidance on disclosure requirements and recommendations which businesses must consider in light of the broader environmental, social and governance matters which can significantly drive the value of an entity.

To apply for a subscription to GAAP on DART, click here to start the application process and select the GAAP in the UK package.

For more information about iGAAP on DART, including pricing of the subscription packages, click here.

This publication has been written in general terms and we recommend that you obtain professional advice before acting or refraining from action on any of the contents of this publication. Deloitte LLP accepts no liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 1 New Street Square, London, EC4A 3HQ, United Kingdom.

Deloitte LLP is the United Kingdom affiliate of Deloitte NSE LLP, a member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"). DTTL and each of its member firms are legally separate and independent entities. DTTL and Deloitte NSE LLP do not provide services to clients. Please see www.deloitte.com/about to learn more about our global network of member firms.

© 2023 Deloitte LLP. All rights reserved.

Designed and produced by CoRe Creative Services RITM1282203