

# CONNECT THE GAAP

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## Connect the GAAP: Ind AS 36 – Impairment of Assets

The asset side of a balance sheet reflects the financial health and strategic growth of any corporation. An essential feature of balance sheets and financial statements is the accuracy in the disclosed carrying values of non-financial assets and goodwill. Under Indian Generally Accepted Accounting Principles (GAAP), Accounting Standard (AS) 28 prescribes the guidelines for the impairment accounting of non-financial assets and goodwill. The Indian Accounting Standard (Ind AS) counterpart of AS 28, Ind AS 36 may be considered a more substantive guideline. Ind AS 36 includes investments in subsidiaries, joint ventures and associates under its scope which AS 28 did not. With annual impairment testing of assets becoming a necessity in accurate financial reporting, its implementation is difficult for many financial controllers and accountants in the corporate world today. This month we discuss Ind AS 36: Impairment of Assets. Though the basic concept of impairment stays unchanged, Ind AS 36 brings a concept-driven approach in dealing with issues such as calculation of value in use, impairment of goodwill, etc. This edition draws a comparison between the existing AS 28 and Ind AS 36 and highlights the new guidelines of impairment accounting brought in by Ind AS 36.

In this issue, we discuss:

- a) Impairment basics
- b) Value in use
- c) Goodwill in a business combination - Allocation and impairment
- d) Impairment of corporate assets
- e) Chronology of charging impairment losses within a single Cash Generating Unit (CGU)
- f) Reusing recoverable amount calculations
- g) Applicability to specified financial assets
- h) Comprehensive comparison

### The impairment basics

The basic objective of impairment accounting is to ensure that assets are carried at no more than their recoverable amount. Impairment loss is the excess of carrying value over the recoverable amount of the asset being tested for impairment. The recoverable amount is the higher of:

- The value in use (present value of all estimated future cash inflows to be derived from the asset); and
- The fair value of the asset net of the costs of disposal.

Impairment is calculated for an individual asset or for a single CGU if such individual assets do not generate independent cash flows.

To know more about AS 28, the previous accounting standard for impairment of assets, read our December issue of Assurance Insights [here](#).

Ind AS is in line with the International Financial Reporting Standards (IFRS) and US GAAP by basing the fair value of the asset on assumptions of the market participants and not those of the reporting entity.

AS 28 on the other hand prescribes the recoverable amount to be the higher of:

- Value in use; and
- Net selling price (NSP)

Ind AS 36, being more substantive than the existing AS 28, places more emphasis on market-based fair value projections. Ind AS 36 also requires the following assets to be tested for impairment annually, regardless of any indication of impairment:

- Intangible asset with indefinite useful life;
- Intangible assets not yet available for use; and
- Goodwill acquired in a business combination

## Value in use

Value in use is defined as the present value of the future cash flows expected to be derived from an asset or CGU. Ind AS 36 gives additional guidance on the following aspects to arrive upon the value in use compared to the existing AS 28:

- Elements to be reflected in calculation of value in use;
- Management assessments on cash flow projections; and
- Use of present value techniques in measuring the asset's value in use.

## Elements to be reflected in calculation of value in use

Ind AS 36 specifically states that the following elements shall 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.

## Management assessments on cash flow projections

Ind AS 36 requires the management to assess the reasonableness of the assumptions on which its current cash flows are based. The management is required to examine the causes of differences between past cash flow projections and actual cash flows to make this assessment.

Generally, these estimates are to be based on budgets/forecasts over a maximum period of five years and extrapolation of cash flows beyond that period based on the steady or declining growth rate unless an increasing rate can be justified.

## Use of present value techniques in measuring the asset's value in use

Ind AS 36 lays down two approaches to determine the present value of future cash inflows to determine the value in use of an asset. The elements to be reflected in value in use as highlighted above can be incorporated as adjustments to future cash flows or to the discount rate depending upon the approach used.

## The traditional approach

The traditional approach is based on a single set of estimated cash flows and a single discount rate, often described as 'the rate commensurate with the risk'.

This approach assumes that a single discount rate convention can incorporate all the expectations of future cash flows. The core focus of this approach is the selection of an appropriate discount rate.

The traditional 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. A minimum of two items need to be analysed to arrive upon an appropriate discount rate:

- An asset that exists in the marketplace having an observed interest rate; and
- The asset in question being measured by the reporting entity.

The reporting entity must follow this process to arrive upon an appropriate discount rate:

- Identify the set of cash flows that will be discounted;
- Identify another asset in the marketplace that appears to have similar cash flow characteristics;
- Compare the cash flow sets from the two items to ensure that they are similar (for example, checking whether both sets have contractual cash flows or whether one is contractual while the other is an estimated cash flow);
- Evaluate whether there is an element in one item that is not present in the other (for example, whether an item is less liquid than the other); and
- Evaluate whether both sets of cash flows are likely to behave (i.e. vary) in a similar fashion through changing economic conditions.

## The expected cash flow approach

The expected cash flow approach uses all expectations about possible cash flows rather than just a single most likely cash flow as done by the traditional approach. This approach allows the use of present value techniques when there may exist variability with respect to the amount of cash flow or its timing. The expected cash flow approach is numerically illustrated below and emphasises on the variability in the amount and time of cash inflows

When the expected amount of cash inflows maybe uncertain but the timing of inflow is certain

Possible cash inflow	Probability of inflow	Expected cash inflow
100	0.10	10
200	0.60	120
300	0.30	90
<b>Expected Cash inflow</b>		<b><u>220</u></b>

### When the timing of cash inflow is uncertain but the expected cash inflow is certain

At the end of year 1, there is a 10% probability of an inflow of INR 1000 and the company considers 5% to be its cost of capital.

At the end of year 2, there is a 60% probability of an inflow of INR 1000 and the company considers 5.25% to be its cost of capital.

At the end of year 3, there is a 30% probability of an inflow of INR 1000 and the company considers 5.50% to be its cost of capital.

Year	Possible cash inflow	Discount rate	Discount factor	Present value of cash inflow	Probability	Expected cash inflow
1	1000	5.00%	0.95238	952.38	0.10	95.24
2	1000	5.25%	0.90273	902.73	0.60	541.64
3	1000	5.50%	0.85161	851.61	0.30	255.48
<b>Expected cash inflows</b>						<b>892.36</b>

The application of an expected cash flow approach is subject to a cost-benefit constraint. In some cases, an entity may have access to extensive data and may be able to develop many cash flow scenarios. In other cases, an entity may not be able to develop more than a few general statements about the variability of cash flows without incurring substantial cost. The entity needs to balance the cost of obtaining additional information against the additional reliability that information will bring to the measurement.

### **Goodwill in business combination- Allocation and impairment**

Both the standards (AS 28 and Ind AS 36) provide specific guidance in relation to the impairment of CGUs and goodwill. As per AS 28, while testing a CGU for impairment, enterprises are required to identify whether the goodwill that relates to the CGU in question is recognised in the financial statements. The two scenarios envisaged are:

- Goodwill can be reasonably and consistently allocated to CGUs: Bottom-up test is performed to assess if there has been impairment loss.
- Goodwill cannot be reasonably and consistently allocated to CGUs: Top-down test is performed to assess if there has been impairment loss.

### **Allocating goodwill to CGUs under Ind AS**

Ind AS 36 provides guidance on allocating goodwill acquired in a business combination to a CGU. This standard prescribes that goodwill is to be allocated to the CGU on the basis of the benefits that will arise from the synergies of the business combination. Hence, it is clear that goodwill arising on account of a business combination may not necessarily be allocated to a specified CGU. It recognises that goodwill may not always be allocated to an individual CGU except on an arbitrary basis, in such situations it is allocated to smallest group of CGUs. Each CGU or group of CGUs to which goodwill is allocated shall:

- Represent the lowest level within the entity at which goodwill is monitored for internal management purposes; and
- Not be larger than any operating segment before such goodwill is allocated. (***operating segments are defined in paragraph 5 of Ind AS 108***)

### **Testing CGU with goodwill for impairment**

The impairment test for goodwill, allocated to a CGU or a group of CGUs, prescribed by Ind AS goes beyond the mere arithmetic allocation of goodwill to CGUs. Ind AS examines the way an entity manages its operations to which goodwill would naturally be associated with. Simply speaking, it assesses that level of the unit which is to derive a higher cash inflow owing to the synergetic benefits of a business combination. The internal management of the entity has to monitor whether the unit actually derives incremental cash inflows due to synergetic benefits. If the entity does not derive any benefits that can be cardinally quantified, it indicates that the allocated goodwill to the unit has been impaired. The manner and frequency at which the impairment test has to be performed can be iterated as follows:

- Individual CGU to whom goodwill has not been allocated will be tested for impairment when such units show indications of impairment. Impairment testing is done by comparing the carrying amount of the CGU excluding goodwill with the recoverable amount.
- Individual CGUs to whom goodwill has been allocated will have to be tested for impairment:
  - On an annual basis; and
  - Whenever such units show indications of impairment.

Impairment testing is done by comparing the carrying amount of the CGU including goodwill with the recoverable amount.

It must be noted that impairment tests can be performed at any time during the annual period provided the test is performed at the same time every year. In case some or all of the goodwill has been allocated to the CGU owing to a business combination in the current year, the impairment test must be performed before the end of the current period.

### Disposal of units to which goodwill has been allocated

A CGU to which goodwill has been allocated may comprise of different operations. In case one such operation has been disposed off:

- Goodwill associated with such operation will be measured on the basis of the relative values of operations disposed and the portion of the CGU retained (unless another basis is justified); and
- The goodwill so associated with the disposed off operations will be included in the carrying amount of the said operation for determining the gain/loss on disposal.

### Change in allocation of goodwill amongst CGUs

Entities may change their reporting structure in ways that may result in a change in the composition of one or more CGUs to whom goodwill has been allocated. In such cases, the goodwill must be reallocated to the units affected. This reallocation shall be performed using a relative value approach similar to that used when an entity disposes of an operation within a CGU, unless the entity can demonstrate that some other method better reflects the goodwill associated with the reorganised units.

### Reversal of impairment loss for goodwill

An impairment loss recognised for goodwill shall not be reversed in the subsequent period. Any increase in the recoverable amount of goodwill in the periods following the recognition of an impairment loss for that goodwill is likely to cause an increase in internally generated goodwill rather than a reversal of the impairment loss recognised for the acquired goodwill.

### Impairment of corporate assets

Corporate assets are defined as assets other than goodwill that contribute to the future cash flows of both the CGU under review and other CGUs. Corporate assets include group/divisional/departmental assets such as the building of a corporate headquarters (HQ), electronic data processing equipment (EDP equipment), research centres, etc. As their definition and nature suggests, corporate assets are used to support the

functions of one or more CGU/division/department of an entity. These assets do not generate any cash flows independent of the entity units to which they provide support to. Hence, they are to be **reasonably and consistently** allocated to each CGU or a group of CGUs. This allocation helps check whether the CGU in question has the ability to recover the carrying value of its core assets and also the corporate assets that are allocated to it. If such allocations are not made, the CGU may appear to be fully recoverable when an impairment loss has occurred. A challenge may arise in situations where the corporate asset cannot be reasonably and consistently allocated to any CGU. However, Ind AS 36 prescribes a treatment to resolve these challenges. Let us consider the example below:

An entity has two CGUs, namely CGU-I and CGU-II, whose carrying values are INR 20 million and INR 30 million respectively. The entity has two corporate assets – the building headquarters and EDP equipment with carrying values of INR 8 million and INR 2 million respectively. The building headquarters can be reasonably and consistently allocated while allocating EDP equipment is not possible for the management. The recoverable amounts of CGU-I and CGU-II are INR 25 million and INR 30 million respectively.

#### Level I impairment test (INR million)

Particulars	CGU-I	CGU-II
Carrying values	20	30
HQ building allocated in 2:3 ratio	3.2	4.8
Total carrying value	23.2	34.8
Recoverable amounts	25	30
<b>Level I impairment loss</b>	<b>NA</b>	<b>4.8</b>

Individual CGUs are tested for impairment by allocating the carrying amounts of those corporate assets that can be reasonably and consistently allocated.

The total carrying value is then compared with the recoverable amounts to determine any impairment.

#### Level II impairment test (INR million)

Particulars	CGU-I	CGU-II	Total
Revised carrying values	23.2	30	53.2
EDP equipment			2
<b>Total carrying value</b>	<b>23.2</b>	<b>30</b>	<b>55.2</b>
Recoverable amount	25	30	55
<b>Level II impairment loss</b>			<b>0.2</b>

An overall level impairment test is performed by aggregating the carrying value of the CGUs and the corporate assets that cannot be reasonably and consistently allocated.

This total carrying value is then compared with the recoverable amount to determine any impairment.

## Chronology of charging impairment losses within a single CGU

An impairment loss arises in the case of a CGU when the recoverable amount of the unit is less than the carrying amount of the unit. Ind AS 36 specifies that such impairment loss shall be allocated in the following order:

**Step 1:** Reduce the carrying amount of any goodwill allocated to the CGU.

**Step 2:** Allocate the balance impairment loss to the other assets of the unit pro rata on the basis of the carrying amount of each asset in the unit.

**Example:** Entity A has a CGU AX-1 to which goodwill has been allocated. The carrying values of various assets in AX-1 are:

Particulars	INR
Allocated goodwill	70,000
EDP equipment	1,50,000
Furniture and fixtures	50,000
Accounting software	1,00,000
<b>Total carrying value</b>	<b>3,70,000</b>

The recoverable amount of AX-1 is estimated to be INR 2,00,000.

Carrying value	3,70,000
Recoverable amount	2,00,000
<b>Impairment loss to be apportioned</b>	<b>1,70,000</b>

**Step 1:** Adjusting Impairment loss against goodwill

Particulars	INR
Goodwill in CGU	70,000
Less: Impairment loss allocated	70,000
Balance impairment loss to be allocated on a pro rata basis to the other assets in the CGU	1,00,000

**Step 2:** Allocation of balance impairment loss (INR 1,00,000) in the ratio of the carrying values of the assets in the CGU.

Particulars	EDP	Furniture and fixtures	Accounting software
Carrying value	1,50,000	50,000	1,00,000
Impairment loss to be allocated in 3:1:2 ratio	(50,000)	(16,667)	(33,333)
Revised carrying values	1,00,000	33,333	66,667

## Reusing recoverable amount calculations

A CGU to which goodwill has been allocated will have to be tested for impairment on an annual basis. Computing the recoverable amount of a CGU on an annual basis is a tedious and time consuming activity. Ind AS 36 permits entities to reuse the calculation of the recoverable amount of CGU that was estimated in the previous reporting period. This calculation can be reused provided all of the following criteria are met:

- The assets and liabilities making up the unit have not changed significantly since the most recent recoverable amount calculation;*
- the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; and*
- based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the current carrying amount of the unit is remote.*

## Applicability to specified financial assets

Ind AS 36 applies to financial assets classified as:

- Subsidiaries as defined in Ind AS 110: Consolidated Financial Statements;
- Associates as defined in Ind AS 28: Investments in Associates and Joint Ventures; and
- Joint ventures as defined in Ind AS 111: Joint Arrangements.

Guidance on impairment to other financial assets is provided by Ind AS 109: Financial Instruments.

AS 28 does not apply to any of the assets mentioned above.

## Impairment indicators for investments in subsidiaries, joint ventures or associates

For impairment losses to be recognised and measured for investments made in subsidiaries, joint ventures or associates, the investor entity must first recognise a dividend from investments made in such entities.

After recognition of such dividends, Ind AS 36 provides two indicators to assess if the investment made in the subsidiary/joint venture/associate is impaired:

**Indicator 1:** Check if the carrying amount of the investment in the stand-alone balance sheet of the investor exceeds the carrying amount of the net assets including goodwill in the consolidated balance sheet.

To understand this first indicator, consider the following numerical:

A Ltd holds 70% of the equity shares of B Ltd as on 1 April 2015 for INR 32,00,000. The details of B Ltd are as under:

Particulars	1 April 2015	31 March 2016
Net Assets/Equity	40,00,000	25,00,000

Net loss for the period INR 15,00,000.

The application of the above indicator for performing an impairment test would be:

Particulars	INR as on 31 March 2016
Valuation as per the consolidated financial statements – Net assets of B Ltd (subsidiary company)	25,00,000
Goodwill (INR 32,00,000 – INR 40,00,000 x 70%)	4,00,000
	29,00,000
Carrying amount in the separate financial statement of the parent	32,00,000

The carrying amount of net assets including the goodwill in the consolidated balance sheet is lower than the carrying amount of assets of the subsidiary in its stand-alone balance sheet. This indicates that the investment in the subsidiary may be impaired.

**Indicator 2:** Check if the dividend from the subsidiary, joint venture or associate exceeds the total comprehensive income of the subsidiary, joint venture or associate in the period in which the dividend is declared.

To understand this concept, let us consider the following example:

B Ltd is the wholly owned subsidiary company of A Ltd. B Ltd pays an equity dividend of INR 2,00,000 to A Ltd on an annual basis since the year of its incorporation. In financial year 2015-16, the company faced stiff price competition in the market owing to which it generated INR 1,80,000 as the comprehensive income for the period. Staying true to its practice, it paid a dividend of INR 2,00,000 to A Ltd. In this case, the subsidiary has paid an amount of dividend greater than its comprehensive income. Although reliance may be placed on its reserves, the dividend declared by the company is in excess of its comprehensive income and hence is an indicator of impairment.

## Comprehensive Comparison

Point of difference	Ind AS	IFRS	US GAAP
Procedure for impairment testing	Prescribes a one step impairment test procedure Impairment loss = Carrying value of asset (-) recoverable amount of asset. The recoverable amount is the higher of: <ul style="list-style-type: none"> <li>▪ Fair value less cost to sell; and</li> <li>▪ Value in use.</li> </ul> Impairment loss = Carrying value – recoverable amount	Same as Ind AS	Prescribes a two step impairment test. <b>Step 1:</b> Compare carrying value with expected cash inflows. If the carrying value is greater than cash inflows, proceed to step 2. <b>Step 2:</b> Compare carrying value with fair value based on market participants estimates. Impairment loss = Carrying value – fair value
Market rate as an indicator of impairment	A change in market rate of interest is considered an indicator suggestive of impairment	Same as Ind AS	A change in market rate of interest is not considered an indicator suggestive of impairment
Future cash flow estimates in impairment analysis	Cash flow estimates are based on the continuing use/activities of the CGU	Same as Ind AS	Cash flow estimates are made on the existing service potential of the asset over its remaining useful life
Revaluation/carrying basis	Allows all items of property, plant and equipment to be stated at fair value	Same as Ind AS	Prohibits the revaluation of property, plant and equipment. Only a few categories of financial instruments can be revalued under the US GAAP

<b>Point of difference</b>	<b>Ind AS</b>	<b>IFRS</b>	<b>US GAAP</b>
Reversal of impairment losses	All impairment losses except for goodwill can be reversed	Same as Ind AS	Any reversals to impairment losses are prohibited
Value in use	Ind AS requires discounted cash flows to base the calculations for value in use	Same as Ind AS	US GAAP requires undiscounted cash flows to base the calculations for value in use

## **In retrospect**

Ind AS 36 is a more comprehensive guideline on impairment accounting compared to its predecessor AS 28. The inclusion of criteria for recognition and measurement of impairment to investments made in subsidiaries, joint ventures and associate companies is a key point of difference between both standards. Also, the new standard specifies guidelines to measure and recognise impairment losses for non-controlling interests in subsidiary companies.

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