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ACCOUNTING ALERT

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COMMON ERRORS IN ACCOUNTING FOR IMPAIRMENT – PART 1

Despite the accounting standards being very clear on a particular accounting treatment, preparers regularly ignore the clear instructions in the standard, resulting in their financial statements being potentially materially misstated.

Perhaps the most common situation where this occurs for Tier 1 and Tier 2 entities is testing for impairment and the application of NZ IAS 36 *Impairment of Assets* (or the equivalent standards for public benefit entities - PBE IPSAS 21 *Impairment of Non-Cash-Generating Assets* and PBE IPSAS 26 *Impairment of Cash-Generating Assets*). (Note, the requirements for PBE IPSAS 21 and PBE IPSAS 26 are similar to those of NZ IAS 36, and thus have not been separately addressed in this article.)

While estimating an asset's recoverable amount requires a great degree of judgement and estimation, in a number of cases there are a set of very clear rules, which are commonly overlooked. These include:

- Not testing for impairment when the standard clearly requires it
- Not testing for impairment at the correct 'unit of account'
- Not including the correct assets in the impairment test
  - Basic errors in determining recoverable amount
  - Basic errors in determining 'value in use'
  - Basic errors in determining 'fair value less cost of disposal'.

This month we will discuss the first error, i.e. not testing for impairment when the standard clearly requires it. We will discuss the remaining errors in future editions of *Accounting Alert*.

Basic requirement of NZ IAS 36

The basic requirement of NZ IAS 36 is very simple.

> 'An asset is impaired when its carrying amount exceeds its recoverable amount.'
> NZ IAS 36, paragraph 8

Not testing for impairment, when the standard clearly requires it

There are five basic situations where NZ IAS 36 requires an asset to be tested for impairment:

- The asset is goodwill
- The asset is an intangible asset with an indefinite useful life
- The asset is an intangible asset not yet available for use
- There are external indicators that an impairment trigger has taken place
- There are internal indicators that an impairment trigger has taken place.

Testing goodwill for impairment

NZ IAS 36 clearly says:

> 'Irrespective of whether there is any indication of impairment, an entity shall also test goodwill acquired in a business combination for impairment annually in accordance with paragraphs 80–99.'
>
> NZ IAS 36, paragraph 10(b)

A common error is to assume that goodwill acquired during the current financial year is not subject to an impairment test. This is not true. All goodwill is subject to impairment testing, even if it arose as a result of a business combination during the current year.

Testing an intangible asset with an indefinite useful life for impairment

NZ IAS 36 also clearly says:

> 'Irrespective of whether there is any indication of impairment, an entity shall also test an intangible asset with an indefinite useful life for impairment annually by comparing its carrying amount with its recoverable amount…'
>
> NZ IAS 36, paragraph 10(a)

Therefore entities with intangible assets that they have determined to have indefinite useful lives, and are not amortising, must perform an impairment test on these brands, mastheads, licences, etc.

Testing an intangible asset not yet available for use

> 'Irrespective of whether there is any indication of impairment, an entity shall also test an intangible asset not yet available for use for impairment annually by comparing its carrying amount with its recoverable amount…'
>
> NZ IAS 36, paragraph 10(a)

Note that this requirement also applies to entities capitalising development costs under NZ IAS 38 *Intangible Assets*. It also raises the question of whether development of a mine is a tangible or intangible asset, remembering that at the point in time when an exploration and evaluation asset transfers to the development phase, it must be tested for impairment under NZ IFRS 6 *Exploration for and Evaluation of Mineral Resources*.

There are external indicators that an impairment trigger has taken place

At each reporting date (this includes the half-year if half-year financial statements are produced), an entity is required to assess whether there is any indication of impairment. This includes goodwill and indefinite life intangibles.

'An asset is impaired when its carrying amount exceeds its recoverable amount. Paragraphs 12–14 describe some indications that an impairment loss may have occurred. If any of those indications is present, an entity is required to make a formal estimate of recoverable amount.'

NZ IAS 36, paragraph 8

'An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset.'

NZ IAS 36, paragraph 9

External indicators of impairment

'In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

External sources of information

a) there are observable indications that the asset's value has declined during the period significantly more than would be expected as a result of the passage of time or normal use.

b) significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.

c) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

d) the carrying amount of the net assets of the entity is more than its market capitalisation.'

NZ IAS 36, paragraph 12(a) to (d)

The above non-exhaustive list raises a number of conditions where, if one of the events listed above has occurred, an impairment test *must* take place. This is in addition to the usual annual impairment testing of goodwill.

If your net assets are greater than your market capitalisation, you must test for impairment.

You can also see from NZ IAS 36, paragraph 12(b) requirements above, that an external indicator of impairment is 'significant changes with an adverse effect on the entity have taken place during the period, **or will take place in the near future**, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.' This requires you to perform impairment tests in advance of actually being impacted by new technology or new legislation, and arguably, impairment write-downs should occur at least a year in advance of operating losses.

There are internal indicators that an impairment trigger has taken place

NZ IAS 36, paragraph 12 goes on to list the following **internal indicators** of impairment:

Internal indicators of impairment

'In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

Internal sources of information

e) evidence is available of obsolescence or physical damage of an asset.

f) significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.

g) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.'

NZ IAS 36, paragraph 12(e) to (g)

These requirements highlight the importance of tying internal budget information into impairment testing assessments and calculations. Failing to do so may result in errors occurring, for example, if you have no impairment write-downs but you have internal budgets showing that:

- The asset is not as profitable as budgeted
- The asset has cost more to construct than was budgeted, or
- The asset has taken longer to construct or get into production than budgeted.

'Evidence from internal reporting that indicates that an asset may be impaired includes the existence of:

Internal sources of information

a) cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted;

b) actual net cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted;

c) a significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset; or

d) operating losses or net cash outflows for the asset, when current period amounts are aggregated with budgeted amounts for the future.'

NZ IAS 36, paragraph 14

Again, preparers must realise that impairment testing is required to consider planned *future* events such as disposals, reorganisations, etc. If there are plans to close a facility early, or to undertake a major refurbishment of that facility, an impairment test must be performed.

It must also be recognised that this list is not exhaustive.

'The list in paragraph 12 is not exhaustive. An entity may identify other indications that an asset may be impaired and these would also require the entity to determine the asset's recoverable amount or, in the case of goodwill, perform an impairment test in accordance with paragraphs 80–99.'

NZ IAS 36, paragraph 13

Next month

In next month's Accounting Alert we will look at the common error of not testing for impairment at the correct 'unit of account'.

For more on the above, please contact your local BDO representative.

CLARIFICATIONS TO NZ IFRS 15 REVENUE FROM CONTRACTS WITH CUSTOMERS

Background

On 12 May 2016, the New Zealand Accounting Standards Board (the Board) issued amendments to the new revenue Standard, NZ IFRS 15 *Revenue from Contracts with Customers*. The amendments clarify some requirements and provide additional transitional relief for companies implementing NZ IFRS 15, which is applicable to all Tier 1 and Tier 2 for-profit entities in New Zealand.

The changes do not change the underlying principles of NZ IFRS 15, rather, they merely clarify how those principles should be applied.

What are the amendments?

The amendments clarify how to:

- Identify a performance obligation (the promise to transfer a good or a service to a customer) in a contract
- Determine whether a company is a principal (the provider of a good or service) or an agent (responsible for arranging the good or service to be provided), and
- Determine whether the revenue from granting a licence should be recognised at a point in time or over time.

The amendments also include two additional transitional reliefs to reduce cost and complexity when a company first applies IFRS 15. These are discussed in more detail below.

Identifying performance obligations

NZ IFRS 15 requires revenue recognition for each separate performance obligation.

You have a separate performance obligation if your sales contract includes a promise to transfer to a customer a good or service that is 'distinct'.

A good or service promised to a customer is 'distinct' if (NZ IFRS 15, paragraph 27):

- The customer can benefit from the good or service either on its own or together with resources that are readily available to the customer, and
- Your promise to deliver the good or service is **separately identifiable** from other promises in the contract.

NZ IFRS 15, paragraph 29 previously included factors that could indicate that your promise to transfer a good or service is **separately identifiable**. This wording was confusing because paragraph 29 was written in the negative, i.e. to be separately identifiable, you would **not be able** to do certain things (integration work, modification and there would not be interdependencies or interrelationships between the products).

Thankfully this paragraph has been reframed so that two or more promises **are not separately identifiable** (i.e. they must be 'bundled') if:

- You do a significant amount of work to integrate the good or service with other goods or services promised in the contract, or
- One or more of the goods or services you provide significantly modifies or customises, or are significantly modified or customised by other goods or services promised in the contract, or
- Goods or services provided are highly interdependent or interrelated.

To clarify the concept of a 'distinct' good or service, the examples 10, 11 and 12 have been amended, and additional scenarios have been added for installation services, multiple items and equipment/consumables.

Principal vs agent considerations

NZ IFRS 15, as originally issued, included significantly more guidance to determine whether you are acting as principal or agent in a contract with a customer. However, due to the fact that the assessment of the transfer of control for items purchased online is more complex in comparison to tangible assets, these changes clarify that the principal obtains control of the good or service prior to transferring it to the customer.

It is interesting to note that guidance paragraph B34 has been reframed from listing indicators to identify agency relationships, to instead listing indicators of when an entity could be acting as principal. In doing so, it has removed the credit risk indicator, so that exposure to credit risk is no longer an indicator that an entity is acting as principal.

Examples 45 to 48A have been amended accordingly.

Licensing

When licenses are 'distinct' from other goods or services identified in a contract, NZ IFRS 15 requires that we determine whether the license transfers to the customer **over time (right to access intellectual property)** or **at a point in time (right to use intellectual property)**.

With a promise to provide access to intellectual property (IP), the contract would normally require, or the customer would reasonably expect, that the entity will **undertake activities that significantly affect the IP**. The amendments provide additional guidance to determine when the entity's activities will significantly affect the IP, i.e. when:

- The activities are expected to change the form or functionality, or
- The ability of the customer to derive benefits from the intellectual property is substantially derived from, or dependent on, those activities.

The additional guidance clarifies that if the IP has significant standalone functionality (e.g. biological compounds or drug formulas), the IP would not be significantly affected by the entity's activities unless those activities change the form or functionality.

The amendments also make changes to examples 54 to 59.

Further guidance is also proposed on sales-based or usage-based royalties and examples 60 and 61 are amended.

Practical expedients

Concerns were raised about the potential challenges in applying full retrospective restatement to certain aspects of the NZ IFRS. As a result, the amendments include two additional practical expedients on transition to NZ IFRS 15 as follows:

- To permit entities to use hindsight to identify satisfied and unsatisfied performance obligations, and the transaction price, in a contract that was modified before the beginning of the earliest period presented, and
- To permit entities using the full retrospective method not to apply NZ IFRS 15 retrospectively to contracts that were complete at the beginning of the earliest period presented.

When do these amendments apply?

The amendments have the same effective date as NZ IFRS 15, i.e. for annual periods beginning on or after 1 January 2018.

For more on the above, please contact your local BDO representative

WHAT'S NEW FOR 30 JUNE 2016 ANNUAL FINANCIAL STATEMENTS?

Public Benefit Entities

For Not-for-profit Public Benefit Entities with a 30 June 2016 reporting date, this is the first reporting period that the new Public Benefit Entities ("PBE") accounting frameworks need to be complied with (i.e. it is the first period after 1 April 2015, the effective date of the new PBE accounting frameworks). What accounting framework you previously reported under, and what tier you are required to report under now, will impact on the magnitude of your transition to the PBE Standards.

For more on the impact of the new PBE accounting frameworks, Tier 1 and Tier 2 entities please refer to the September 2014 edition of Assurance Alert and Tier 3 and Tier 4 entities, the January 2013 of Assurance Alert and November 2015 editions of Accounting Alert.

For Public Sector Public Benefit Entities, this is the second year end of reporting under the new PBE Standards, and the good news is that there are no new standards effective for the first time for 30 June 2016 year ends.

For-profits - the good news

Tier 1 and Tier 2 for-profits for 30 June 2016, the good news is that there are no new accounting standards, and only one small change to NZ IAS 28 *Investments in Associates and Joint Ventures* that could impact your 30 June 2016 annual financial statements for the first time.

The calm before the storm

However, this is just the calm before the storm, with NZ IFRS 9 *Financial Instruments* and NZ IFRS 15 *Revenue from Contracts with Customers* effective for your 30 June 2019 annual periods, and NZ IFRS 16 *Leases* effective for June 2020. In addition, there are numerous changes to existing accounting standards that are effective from 1 January 2016 (including the disclosure initiative) which may impact your 30 June 2017 financial statements.

The disclosure initiative

The disclosure initiative is a broad-based project that aims to improve disclosure in general purpose financial statements. The International Accounting Standards Board (IASB) has currently completed two disclosure initiative projects and is working on further projects in this area.

The two completed disclosure initiative projects have been adopted and issued by the New Zealand Accounting Standards Board (NZASB), being:

- Amendments to NZ IAS 1 *Presentation of Financial Statements* – effective for periods beginning on or after 1 January 2016
- Amendments to NZ IAS 7 *Statement of Cash Flows* – effective for periods beginning on or after 1 January 2017.

The NZASB has also released similar amendments to the PBE Standards in relation to the disclosure initiative, which are effective for periods beginning on or after 1 January 2016.

Is there any reason to adopt these changes early?

In this first suite of changes made to NZ IAS 1, entities are now able to apply judgement when determining which disclosures to include in their financial reports. This means that you now have the ability to only include disclosures that you consider to be either quantitatively or qualitatively material (or otherwise useful) to users of your financial report.

While such changes are not mandatory for entities with years ending 30 June 2016, the improvements we have seen in listed companies that have early adopted these amendments have significantly improved their financial statements because they are now highlighting information considered to be of high importance to users.

Action points

This process will become mandatory for all Tier 1 and Tier 2 entities with a financial year commencing on or after 1 January 2016, which means that you will be required to go through this decluttering process for your 30 June 2017 financial statements.

Steps you can start now include:

- Conduct a parallel test run on your 30 June 2016 financial statements – start thinking about what your 30 June 2017 final product will look like, and
- Read ED IFRS Practice Statement Application of Materiality to Financial Statements.

For more on the disclosure initiative, please refer to the December 2015 and February 2016 editions of Accounting Alert.

For more on the above, please contact your local BDO representative.

What steps can I take to improve my financial statements?

REMOVE

- Remove unnecessary accounting policies
- Tailor 'boilerplate' wording on accounting policies to suit entity circumstances
- Remove redundant disclosures
- Remove any disclosures duplicated in multiple places
- Make use of cross references.

REORDER

- Move the accounting policies to the relevant note
- Move key accounting estimates and judgements to relevant note
- Move key information to the beginning ofthe financial statements.

REGROUP

- Group similar information within the same note
- Group related notes together
- Consider introducing sections to thefinancial statements.

REEMPHASIS

- Highlight key changes in the financial statements
- Emphasise key information
- Consider use of non-technical language for certain disclosures.

BDO PUBLICATIONS

The News & Resources section of our website (https://www.bdo.nz/en-nz/services/audit-assurance/news-resources) includes a range of publications on accounting standards issues. For example:

- **Summaries on a Page (SOAPs)** contain summaries of NZ IFRS Standards for for-profit entities and PBE Standards for public sector and not-for profit entities currently in effect in New Zealand.

The BDO International site includes resources such as:

- **IFRS at a glance** – 'one page' and short summaries of all IFRS standards.
- **IFRS News at a glance** – provides high-level headlines of newly released documents by the IASB and IFRS related announcements by securities regulators.
- **Need to Knows** – updates on major IASB projects and highlights practical implications of forthcoming changes to accounting standards. Recent Need to Knows include IFRS 9 *Financial Instruments – Classification and Measurement* (April 2015), IFRS 9 *Financial Instruments - Impairment of Financial Assets* (Dec 2014), IFRS 15 *Revenue from Contracts with Customers* (Aug 2014), IFRS 9 *Financial Instruments* (May 2014), *Hedge Accounting* (IFRS 9 *Financial Instruments*) (Jan 2014).
- **IFRS in Practice** – practical information about the application of key aspects of IFRS, including industry specific guidance. Recent IFRS in Practice include IFRS 11 *Joint Arrangements* (Feb 2016), IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers – Transition*; IFRS 15 *Revenue from Contracts with Customers* (Oct 2014), IAS 7 *Statement of Cash Flows*, *Distinguishing between a business combination and an asset purchase in the extractives industry* (March 2014), IAS 36 *Impairment of Assets* (Dec 2013) and *Common Errors in Financial Statements – Share-based Payment* (Dec 2013).
- **Comment letters on IFRS standard setting** – includes BDO comments on various projects of international standard setters, including Exposure Drafts and other Discussion Papers, when it is considered that the issue is significant to the BDO network and its clients. Latest comment letters include IASB ED 2015-08 *IFRS Practice Statement: Application of Materiality to Financial Statements*, IASB ED 2015-11 *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts – Proposed amendments to IFRS 4*, IASB ED 2015-3 *Conceptual Framework for Financial Reporting*, ED *Proposed amendments to IAS 19* and IFRIC 14, IASB 2015-6 *Clarifications to IFRS 15*, IASB ED 2015-1 *Classification of Liabilities* and Basel Committee on Banking Supervision – Guidance on accounting for expected credit losses.

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