INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF KENYA

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ASSET VALUATION AND IMPAIRMENT WORKSHOP

Asset Impairment Red flags and Issues to Watch

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What is an Asset

An asset may be defined as an item with a market, i.e, exchangeable value, which forms part of the wealth or property of its owner.

List of Assets include:

Financial and Non-Financial Assets

Financial Assets are in the form of cash, bank deposits and securities which bring their owners a return in the form of interest on the deposits and bonds or dividends from shares. Financial assets also include a foreign exchange rate as the price of a specific asset - currency.

Non-financial Assets include production factors (land, buildings, machines, vehicles, mineral deposits) and immaterial assets (e.g. patents or trademarks).

Factors Affecting Prices

- Financial and non-financial assets are present in all areas of a society's economic activity.

- They constitute a common ingredient of the portfolios of practically all economic sectors.

- A fundamental factor that determines the prices of specific assets is **supply and demand**.

Factors Affecting Prices

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Factors Affecting Prices

- **Economic cycle** influences asset price developments. The largest difference can be seen in the development of share and bond prices.

- During a recession, share prices fall as a result of falling profits. Bond prices, however, rise in response to the fall in interest rates.

- During a depression, shares continue to have a low, and bonds a high, market value. During the recovery phase, share prices rise together with rising profits, while bond prices begin to fall.

Factors Affecting Prices

- **Expectations** also influence prices.
- This means that share prices can be interpreted as prices reflecting the current value of anticipated future company revenues and real estate prices on the basis of expected future rents.
- Changes in short-term interest rates thus affect long-term rates and asset prices in relation to how monetary policy will affect expected future short-term rates, returns and rents.
- Expectations are based on experience, data that includes various prognoses of economic development and the opinions of central bankers regarding the development of basic macroeconomic indicators.

Factors Affecting Prices

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- Asset prices are also influenced by other factors, which are chiefly present in the new market economies.

- Among them are restricted access to information, weak and uncompetitive markets and volatile macroeconomic variables.

- This means that in order to assess the price development of assets it is necessary to know both the **specific type of asset** and the **structure of factors** that applies to the relevant asset at any given time.

Impairment

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Impairment

- Reduction in the value of an asset because the asset no longer generates the **benefits** expected.

- The term impairment is usually associated with a **long-lived asset** that has a market which has decreased significantly.

- If the undiscounted **future cash flows** from the asset (including the sale amount) are less than the asset's **carrying amount**, an impairment loss must be reported.

- If the impairment loss is to be reported, the amount of the impairment loss must be measured.

Steps to Identify, Recognize and Measure the Impairment

Å **Indicators of impairment**

A long-lived asset (group) that is held and used should be reviewed for impairment **whenever events or changes in circumstances indicate that the carrying amount of the long-lived asset (group) might not be recoverable**, i.e., information indicates that an impairment might exist.

Å **Test for recoverability**

The general purpose of an impairment test is **to ensure that an asset is not carried for financial reporting purposes at an amount that exceeds its recoverable amount;** to do so would overstate a reporting entity's financial position and performance.

Steps to Identify, Recognize and Measure the Impairment

Å **Measurement of an impairment**

IAS 36

Is predominately applicable to property, plant and equipment, intangible assets and goodwill- termed ócash generating unitsôor CGUs

Property, Plant, and Equipment-Indicators

ÅSignificant decrease in the market price of a long-lived asset (asset group)-*PP*

ÅSignificant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition -*RVR*

ÅSignificant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator-*brewing in Kenya*

Property, Plant, and Equipment-Indicators

ÅAn accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset -*REP*

ÅA current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)-*KQ*

ÅA current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.


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External and Internal Indicators of Impairment (IAS 36)

External Indicators

- A significant and more than unexpected decline in market value of the entity
- Changes with an adverse effect on the technological, market, economic or legal environment in which the entity operates, such as:
  - -Increases in levies
  - -The entry of a major competitor into the market
  - -A change in consumer demand that the entity is unable to respond to
- Increases in interest rates, changes in foreign exchange rates, and/or commodity prices
- The carrying amount of the entity’s net assets is more than its market capitalisation

Internal Indicators

- Evidence of obsolescence or physical damage

- Changes in the extent to which an asset is used or is expected to be used, such as:

  -An 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

  -A reassessment of the useful economic life of an asset as finite rather than indefinite.

Internal Indicators

Evidence from internal reporting that the economic performance of an asset is, or will be, worse than expected, such as:

- Cash flows for acquiring the asset, or subsequent cash needs for **operating or maintaining** it, being significantly higher than originally budgeted

- Actual net cash flows or operating profit or loss flowing from the asset are significantly **worse than budgeted**

Internal Indicators

- An increase in the cost of capital (note, this can also be caused by external factors)

- Changes to the entity's business model and/or plans to restructure/discontinue operations

- Shelving or deferral of previously committed capital investment.

Issues to Watch- Common Errors

- Incorrect allocation of assets and liabilities to CGU
- Inconsistent treatment of cashflows-delinking from budgets, reality,
- Inappropriate models
- Reversal of impairment
- Assumptions improperly used

Non-Cash Generating Assets

Å Non-cash-generating assets are assets ***other than cash-generating assets. IPSAS 21***

Å Cash-generating assets are assets held to ***generate a commercial return. IPSAS 26***

Å **Impairment Loss = CA > RSA (Recoverable service amount)**

Å **An entity shall assess at each reporting date whether there is any indication that an asset may be impaired.**

Å **If any such indication exists, the entity shall estimate the recoverable service amount of the asset.**

Impairment Loss

Impairment reflects a **decline in the utility** of an asset to the entity that controls it.

e.g.

An entity may have a purpose-built military storage facility that it no longer uses. In addition, because of the specialized nature of the facility and its location, it is unlikely that it can be leased out or sold, and therefore the entity is unable to generate cash flows from leasing or disposing of the asset.

The asset is regarded as impaired, as it is no longer capable of providing the entity with service potential ï it has little, or no, utility for the entity in contributing to the achievement of its objectives.

Measuring VIU in Recoverable Service Amounts

Å**Depreciated Replacement Cost Approach** = Reproduction or replacement cost (whichever is higher) less acc. depreciation.

Å**Restoration Cost Approach** = (Replacement cost ï Acc depreciation) less restoration cost .

Å**Service Units Approach** = Replacement cost ï acc depreciation.

*Value In Use (VIU)

Measuring Recoverable Service Amount

- RSA = [FV- costs to sell] or value in use (whichever is higher)

- An asset's FV less costs to sell = a price in a binding sale agreement in an arm's length transaction, adjusted for incremental costs that would be directly attributable to the disposal of the asset

- Value in use of a non-cash-generating asset = the PV of the asset's remaining service potential.

Red Flags-Issues to Watch

- Significant long-term changes in the technological, legal or government policy environment

- Significant long-term change in the extent or manner of use, including that identified from the cessation or near cessation of demand.

- Physical damage

EXAMPLE OF NON-CGA GENERATING CASH FLOW

An asset may generate cash flows although it is primarily held for service delivery purposes.

e.g.

A waste disposal plant is operated to ensure the safe disposal of medical waste generated by **state-controlled hospitals**, but the plant also treats a small amount of medical waste generated by other **private hospitals** on a commercial basis.

The treatment of medical waste from the private hospitals is incidental to the activities of the plant, and the assets that generate cash flows cannot be distinguished from the non-cash-generating assets.

Indications of Impairment—Examples

- A school closed because of a lack of demand for school services arising from a population shift to other areas or population decline due to alcohol consumption and family planning. It is not anticipated that this demographic trend affecting the demand for the school services will reverse in the foreseeable future;

- A railway line closed due to lack of patronage due to service deterioration or (for example, the population in a rural area has substantially moved to the city due to successive years of drought, and those that have stayed behind use bus service);

Indications of Impairment—Examples

- Medical diagnostic equipment that is rarely or never used because a newer machine embodying more advanced technology provides more accurate results

- Software that is no longer being supported by the external supplier because of technological advances and the entity does not have the personnel to maintain the software; and

- Computer hardware that has become obsolete as the result of technological development.

Indications of Impairment—Examples

ÅAn automobile that does not meet new emission standards or an airplane that does not meet new noise standards;

ÅA school /university that can no longer be used for instruction purposes due to new safety regulations regarding its building materials or emergency exits; and

ÅA drinking water plant that cannot be used because it does not meet new environmental standards.

Internal Sources of Information -physical damage

(i) A building damaged by fire or flood or other factors;

(ii) A building that is closed due to identification of structural deficiencies;

(iii) Sections of an elevated roadway that have sagged, indicating that these sections of roadway will need to be replaced in 15 years rather than the original design life of 30 years;

(iv) A dam whose spillway has been reduced as a result of a structural assessment;

Internal Sources of Information -physical damage

(v) A water treatment plant whose capacity has been reduced by an intake blockage and the removal of the blockage is not economical;

(vi) A bridge that is weight restricted due to identification of structural deficiencies;

(vii) A navy destroyer damaged in a collision; and

(viii) Equipment that is damaged and can no longer be repaired or for which repairs are not economically feasible.

Internal Sources of Information

Significant long-term changes, with an adverse effect on the entity, in the extent to which an asset is used, or is expected to be used;

Å An example is a mainframe computer that is underutilized because many applications have been converted or developed to operate on servers or PC platforms.

Å A school building that is being used for storage rather than for educational purposes

Internal Sources of Information

A decision to halt the construction of the asset before it is complete or in a usable condition.

Example;

- Construction was stopped due to identification of an archaeological discovery or environmental condition such as a nesting ground for a threatened or endangered species; or

- Construction was stopped due to a decline in the economy.

IFRS 9-Financial Assets

- Replaces the incurred loss model in IAS 39 contributes to delayed recognition of credit losses with the new expected credit loss model.

- Credit losses are not recognised until a credit loss event occurs.

- Mismatch in the timing of the recognition of the **credit spread** inherent in the interest charged on the loans over their lives and any **impairment losses** that only get recognised at a later date

IFRS 9

The standard defines **credit loss** as the difference between all **contractual cash flows** that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original EIR (or credit-adjusted EIR for purchased or originated credit-impaired financial assets).

ECLs Approaches

The standard does not prescribe specific approaches used to estimate ECLs, but stresses that the approach used must reflect the following:

ÅAn unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes

ÅThe time value of money

Å Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions

Expected Credit Loss Model

This ECL model was designed to:

Å Ensure a more timely recognition of ECLs than the existing incurred loss model

Å Distinguish between financial instruments that have significantly deteriorated in credit quality and those that have not

Å Better approximate the economic ECLs

Implications of ECL Model

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- The **scope** of the impairment requirements is now much broader
- The new requirements are designed to result in **earlier recognition** of credit losses
- The ECL model is more **forward looking** than the IAS 39 impairment model.
- The application of the new IFRS 9 impairment requirements is expected to **increase the credit loss allowances**
- The focus on expected losses will possibly result in **higher volatility** in the ECL amounts charged to profit or loss, especially for financial institutions.
- Will require **considerable judgment** as to how changes in macroeconomic factors will affect ECLs.

Issues to Watch or Indicators

- Significant changes in **internal indicators of credit risk** as a result of a change in credit risk,

- Changes in the **terms** of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date

- Significant changes in **external market** indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life.

- An actual or expected significant change in the financial instrument's **external credit rating**.

Issues to Watch or Indicators

ÅAn actual or expected internal **credit rating downgrade** for the borrower

ÅExisting or forecast adverse changes in business, financial or economic conditions

ÅAn actual or expected significant change in the operating results of the borrower.

ÅSignificant increases in credit risk on other financial instruments of the same borrower.

Issues to Watch or Indicators

- An actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower

- Significant changes in the value of the collateral supporting the obligation

- A significant change in the quality of the guarantee provided by a Shareholder

- Significant changes, such as reductions, in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement,

Issues to Watch or Indicators

- Expected changes in the loan documentation
- Significant changes in the expected performance and behaviour of the borrower,
- Changes in the entity's credit management approach in relation to the financial instrument
- Past due information

END

Questions

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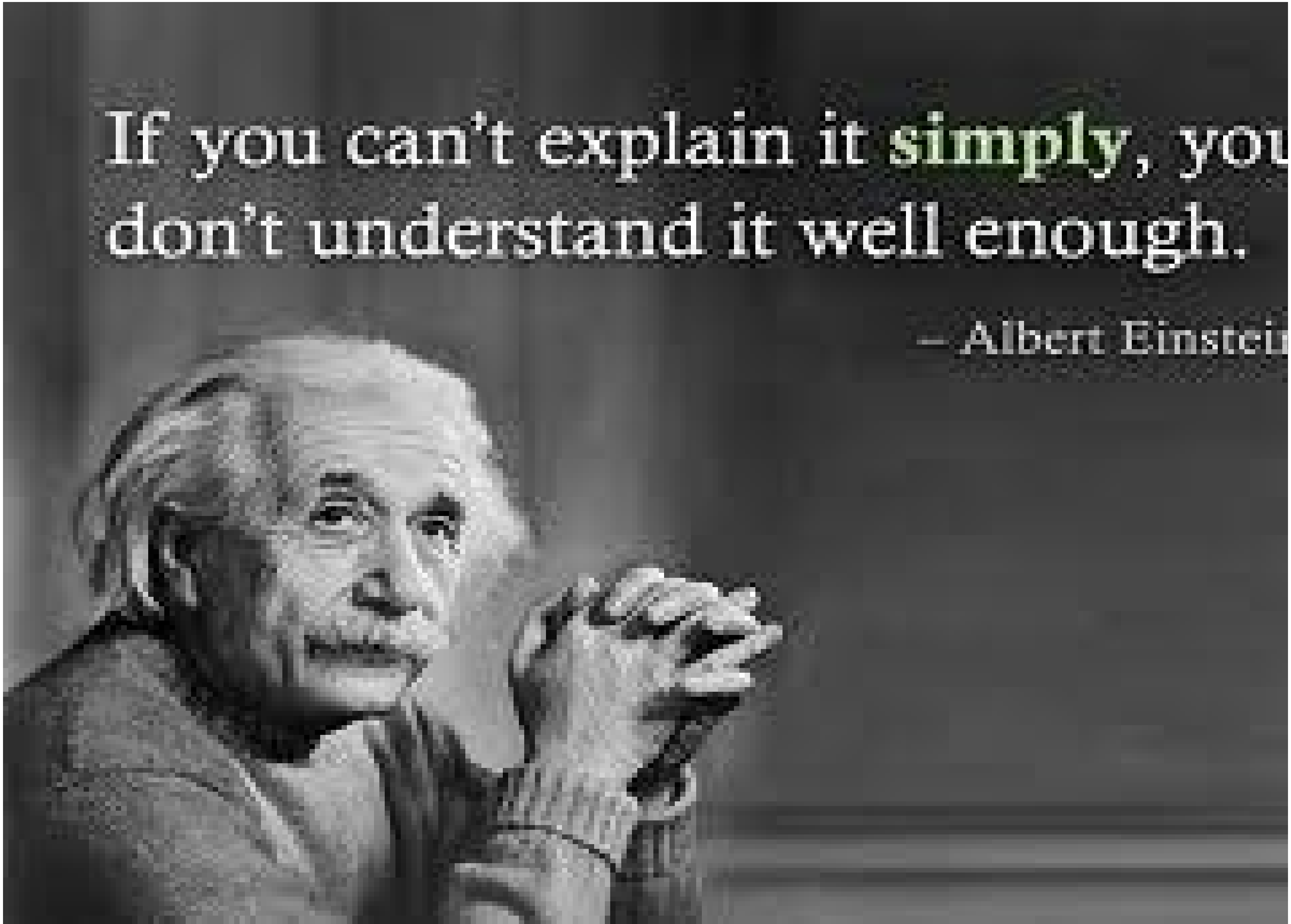
Answers


If you can't explain it simply, you
don't understand it well enough.
– Albert Einstei

Thank you