A CPD seminar held in February on SSAP 31 'Impairment of Assets', attracted an audience of 450. Paul Pacter, Technical Director at Deloitte Touche Tohmatsu, reviewed the new Standard and answered questions

SSAP 31 'Impairment of Assets'

SSAP 31 'Impairment of Assets', is one of a series of six new Standards issued by the Society's Financial Accounting Standards Committee in January which became effective on the first of this year. At each balance sheet date, an enterprise must review its assets to check for any indication that an asset may be impaired. The objectives of SSAP 31 are to ensure that assets are not carried at more than their recoverable amounts, and to define and calculate the recoverable amount clearly.

SSAP 31 has a list of external and internal indicators of impairment. If there is an indication that an asset may be impaired, the enterprise must calculate the asset's recoverable amount.

Q Is SSAP 31 the same as IAS 36?

A They are virtually identical.

Q Is SSAP 31 the same as US GAAP?

A No. SSAP 31 is more detailed than FASB 121. FAS 121 recognises an impairment loss only if the sum of undiscounted cash flows is below the carrying amount; SSAP 31 requires discounting. Under FAS 121, recoverable amount is fair value – value in use is ignored. FAS 121 prohibits reversals of impairment losses. FASB has recently proposed some amendments to FAS 121, but the aforementioned differences will remain.

Q If goodwill has previously been charged against reserves (equity) rather than capitalised, is this goodwill also subject to SSAP 31?

A While not explicit in SSAP 31, in my judgement the answer is yes. Under Hong Kong GAAP, if the subsidiary to which the goodwill relates is sold, the goodwill previously charged to equity is added back before figuring any gain or loss on the disposal. In effect, the goodwill is temporarily 'parked' in equity. If it is impaired, a loss should be recognised.

Q SSAP 31 speaks of a 'bottom up' and a 'top down' test to measure impairment of goodwill. What exactly does this mean?

A The following three-step analysis illustrates the test.

1. Is the asset for which impairment is indicated a single asset or a cash-generating unit (CGU)?
   (a) Single. Measure recoverable amount of that asset.
   (b) CGU. Measure recoverable amount of CGU. Go to step two.
2. If it is a CGU, is there any goodwill associated with the CGU?
   (a) No. For example, if the CGU is a factory that the company built and was not acquired in a business combination there is no associated goodwill. Therefore, the recoverable amount of the factory alone is measured.
   (b) Yes. If the CGU is a factory that was acquired as part of a business combination in which goodwill was recognised, go to step three.
3. Can goodwill be attributed to the factory on a reasonable basis?
   (a) Yes. In the business combination, this high-tech factory was the major asset acquired (along with small amounts of receivables and inventory). The goodwill arose because of the unique production capability of this factory. Therefore, measure the recoverable amount of factory plus goodwill combined. This is the 'bottom up' approach.
   (b) No. The factory was just one of many assets of the acquired business and the goodwill related to the entire business rather than any specific asset such as the factory. Therefore, expand the CGU to include all of the assets of the acquired business, and measure the recoverable amount of all of the remaining assets of the entire acquired business, including the goodwill – not just the factory plus goodwill. This is the 'top down' approach.

The dilemma of the top down approach is that by expanding the CGU, there may be no impairment recognised on the factory. That would happen if, by itself, the factory was performing poorly, while the acquired business as a whole is doing well. But if there is no reasonable basis to allocate goodwill to the factory, the enterprise has no choice but to expand the CGU.

Q SSAP 31 mentions that, in computing value in use, accurate cash-flow projections beyond five years generally cannot be made. If an asset has a life of say 18 years, how is impairment assessed? Surely the cash flows in years 6–18 are not ignored?

A They are not ignored. SSAP 31 says that cash-flow budgets beyond five years normally are not detailed enough to be reliable. In those cases, reliable historical data and budgets for a maximum of five years would be extrapolated to years 6–18 using a growth rate that may be zero or negative.

Q Investment properties are excluded from SSAP 31. However,

some of these are carried at cost under SSAP 13 – if they are held by unlisted companies or groups whose total properties are estimated to be worth less than HK$50 million. Do these escape impairment testing?

A No. Paras 12 and 13 of SSAP 13 require recognition of impairment. In the absence of further guidance in SSAP 13, look to SSAP 31.

Q In computing value in use, would you always discount at a borrowing rate? Are there any situations where a savings rate might be appropriate?

A The discount rate is the rate that reflects current market assessments of the time value of money and the risks specific to the asset. This would be the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk equivalent to those that will be derived from the asset in question. In that sense, it is a savings rate, but it must be asset specific. It is not the enterprise's overall return on investment.

Q Which types of company are most likely to be affected by SSAP 31?

A Certainly companies with high-tech assets will be affected. So will those with a lot of intangible assets. Market prices of both of those categories of assets tend to fluctuate significantly. Additionally, companies whose principal products are nearing the end of their life cycles are also likely to be affected.

Q Property used as a director's residence is expected to be held for a much shorter period than the useful life of the property, but the period is uncertain. How can impairment be assessed?

A In this case, value in use may not be relevant, so impairment is assessed based on the net selling price.

Q Does SSAP 31 allow room for 'directors' opinions' on impairment of assets?

A While assessing impairment is not precise, SSAP 31 tries to base the accounting on hard evidence as much as possible. For instance, the indicators of impairment focus on factual circumstances. Similarly, the SSAP 31 procedures for measuring recoverable amount are based on things such as market-observed borrowing rates, detailed cash-flow budgets that are limited to five years, binding sale agreements and price quotations in active markets. One would expect directors' opinions to be additional potential indicators of impairment, but not a justification to override observable facts.

Q SSAP 31 requires reversal of all or part of an impairment loss recognised in a prior period if circumstances have changed. But it says that an impairment loss is not reversed for 'unwinding' of the discount. What does this mean?

A Value in use is based on the discounted present value of future cash flows. Sometimes, this present value will increase because of the passage of time, because the future cash flows become closer and are discounted less. SSAP 31 allows reversal of an impairment loss only when the expected actual cash flows increase. In this case, the asset will provide greater benefits to the enterprise than previously anticipated, justifying income recognition.

Q Can an impairment loss previously recognised for goodwill be reversed?

A Only if the loss was caused by a specific external event of an unexpected and exceptional nature and a subsequent favourable external event occurs (such as a legal, political, or technological change) that reverses the effect of the earlier event.

Notes to SSAP 31

Exclusions

SSAP 31 applies to all assets except:

- inventories (covered by SSAP 22)
- assets arising from construction contracts (SSAP 23)
- deferred tax assets (SSAP 12)
- financial assets (partly covered by SSAP 24), and
- investment properties (SSAP 13).

SSAP 31 does apply to (among other assets) land, buildings, machinery, equipment, intangible assets, goodwill (new SSAP 30 adds a few additional requirements) and investments in subsidiaries, associates and joint ventures. If a subsidiary is excluded from consolidation under SSAP 30, it must be accounted for as an investment under SSAP 24, which includes impairment provisions.

Definitions

- Under SSAP 31, an asset is impaired when its carrying amount exceeds its recoverable amount.
- Carrying amount is the amount at which an asset is recognised in the balance sheet after deducting accumulated depreciation and accumulated impairment losses.
- Recoverable amount is the higher of an asset's net selling price and its value in use:
  - Net selling price is the amount obtainable from the sale of an asset in a bargained transaction between knowledgeable, willing parties less the costs of disposal, and
  - Value in use is the discounted present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Determining recoverable amount

- If the net selling price or value in use is more than carrying amount, there is no need to calculate the other amount
- If net selling price cannot be determined, then recoverable amount is value in use, and
- For assets to be disposed of, recoverable amount is the net selling price.

Net selling price (NSP)

- If there is an active market for that type of asset, NSP is market price less costs of disposal

- If there is no active market, NSP is the best estimate of the asset's selling price less costs of disposal, and
- Costs of disposal are the direct added costs only (not existing costs or overhead).

Discount rate

The discount rate should be the pre-tax rate that reflects current market assumptions of the time value of money and of the risks specific to the asset.

Impairment loss

An impairment loss is an expense in the income statement and should be recognised whenever recoverable amount is below carrying amount.

Cash-generating unit

The recoverable amounts should be determined for an individual asset, if possible. If it is not possible, the enterprise must determine recoverable amount for the asset's CGU.

The cash-generating unit (CGU) is the smallest identifiable group of assets:

- that generates cash inflows from continuing use, and
- whose cash flows are largely independent of the cash inflows from other assets or groups of assets.

Reversal of impairment loss

SSAP 31 requires that reversal of an impairment loss be recognised as income. The enterprise will follow the same approach as for the identification of impaired assets, namely, assess at each balance sheet date whether there is an indication that an impairment loss may have decreased and, if so, calculate recoverable amount. The increased carrying amount due to reversal should not be higher than what depreciated historical cost would have been if the impairment had not been recognised.

SSAP 31 disclosures

- Disclosure by class of assets:
  - impairment losses recognised in the income statement
  - impairment losses reversed in the income statement, and
  - which line item(s) of the income statement.
- Disclosure by segment (primary segments only – usually product line or industry):
  - impairment losses recognised, and
  - impairment losses reversed.
- If an individual impairment loss (reversal) is material, disclose:
  - events and circumstances resulting in the impairment loss
  - amount of the loss
  - individual asset: nature and segment to which it relates
  - cash generating unit: description, amount of impairment loss (reversal) by class of assets and segment
  - if recoverable amount is net selling price, disclose the basis for determining NSP, and
  - if recoverable amount is value in use, disclose the discount rate.
- If impairment losses recognised (reversed) are material in aggregate to the financial statements as a whole but not individually, disclose:
  - main classes of assets affected, and
  - main events and circumstances.

SSAP 31 is effective from 1 January 2001. It should be applied prospectively. Any impairment loss resulting from adoption of the Standard is recognised in the income statement.

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