

HKFRS News

Shedding light on the HKICPA's activities*

May 2007

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HKFRS has converged with IFRS effective from 1 January 2005. Contents contained in this newsletter are relevant to both HKFRS preparers and IFRS preparers.

HKAS 36 *Impairment* – frequently asked questions

Accounting for impairments is not straight-forward. There are many complexities, including detailed requirements about identifying the assets to be tested, the frequency of testing, measuring the impairment and making the required disclosures.

Impairments not only occur to goodwill, they can affect the carrying value of other intangible and tangible fixed assets. The requirements regarding the testing for impairment of goodwill and other assets differ. This adds to the difficulty in applying the strict requirements of HKAS 36 *Impairment of Assets*.

This newsletter contains frequently asked questions structured around the typical impairment process. They address issues arising at each stage in the process, with reference to the guidance in the standard.

Identifying cash generating units (CGU)

Q1. What are the common factors of independence of cash flows in a CGU?

There are various factors including how management monitors the entity's operations – for example, by product lines, businesses, individual locations, districts or regional areas – and how management makes decisions about continuing or disposing of the entity's assets and operations (HKAS 36.69).

Typical CGUs are:

- individual retail stores;
- an individual factory with a single production line where there is no external market for the product at an intermediate stage (HKAS 36.70); and
- each route service that a transport business provides where the assets deployed to each route as well as the route's cash flows can be separately identified.

Q2. Should management consider the legal structure of the operations in identifying a CGU?

Management's analysis may not reflect the legal structure through which the operations are conducted. Identification of CGUs is driven by the asset and the business and requires judgment.

Q3. Where some or all output produced by an asset or by a group of assets is used internally, is that asset or group of assets identified as a CGU?

If there is an active external market for such output, that asset or group of assets is identified as a CGU. This is particularly relevant for vertically integrated operations where there is likely to be an active market for the product (HKAS 36.71).

Allocating corporate assets and goodwill to CGUs

Q4. What must management do if a corporate asset cannot be allocated on a reasonable and consistent basis to a CGU?

A two-stage test is required (HKAS 36.102):

- Test the CGU without the corporate asset for impairment and book any charge arising; then
- Test the smallest grouping of CGUs to which the corporate asset can be allocated on a reasonable and consistent basis, and record any charge arising.

Example

A retailer has a number of regional warehouses that supply all stores in a region. Each store in the region is a CGU. How does management choose a method to allocate a portion of the warehouse assets to each store?

Solution

Management must identify a non-arbitrary, reasonable and consistent basis to allocate the warehouse costs to each CGU. There are several potential methods of allocation, for example, based on volume or value of deliveries to each store, ratio of size of individual stores to the total floor space in the region, or ratio of workforce at each store to regional workforce.

However, management could argue that the regional warehouse costs cannot be allocated consistently. In this case, they must use the two-stage method and test each warehouse at a regional level by grouping each region's stores and warehouse together.

Q5. In what circumstances can management change the allocation of goodwill to CGUs for impairment testing?

A reallocation of goodwill is only permitted if there is a reorganisation or a restructuring of the business.

Q6. What does it mean when the standard states that goodwill must be allocated to the lowest level at which the goodwill is monitored for internal management purposes?

The level at which management monitors goodwill for internal management purposes is the lowest level at which it reviews the success of an acquisition, by capturing and monitoring the benefits of the goodwill. For example, if a subsidiary makes an acquisition, despite the fact that goodwill will only appear on a consolidated balance sheet level, it is the management team that is held accountable for acquisitions that would monitor goodwill.

The requirement to allocate goodwill should not cause companies to allocate goodwill arbitrarily to CGUs or create a need for new systems for monitoring goodwill. However, the level of allocation cannot be higher than the primary or secondary segment level, even if management monitors it at a higher level (HKAS36.80 BC138).

Q7. Does the adoption of HKFRS 8 *Operating Segments* have any impact on the goodwill reallocation?

The adoption of HKFRS 8 is a trigger for reallocation of goodwill where there is a change in the entity's segments. The standard states that the level of allocation cannot be higher than a segment level.

Q8. A company allocates all goodwill on previous acquisitions to acquired CGUs in line with previous GAAP. Does the requirement to allocate goodwill to CGUs that are expected to benefit from the combination mean that the company will have to reallocate goodwill?

A reallocation of goodwill to the CGUs expected to benefit may be appropriate. The transition rules in HKFRS 1 *First-time Adoption of International Financial Reporting Standards* that freeze the carrying amount of goodwill do not preclude an entity from reallocating the goodwill brought forward.

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