

HKFRS News

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More focus on fair value under the new IFRS 7

What is the issue?

In response to the global financial crisis, earlier this year the IASB amended *IFRS 7 Financial Instruments: Disclosure* to require entities to disclose more information about their financial instruments.

The amendments give users of financial statements more information about the risks associated with the valuations and methodologies entities use. The amendments apply to periods beginning from 1 January 2009 (they are mandatory for annual December 2009 accounts).

Who does it affect?

All entities that measure one or more of their financial instruments at fair value. Financial instruments that are commonly measured at fair value include investments in listed securities, private equity, government securities, government bonds, all derivatives (such as interest rate swaps) and complex financial liabilities.

What are the key changes to IFRS 7 and how do they change current practice?

All financial instruments measured at fair value in the balance sheet must be classified into a new three-level fair value hierarchy (refer to box below). The levels in the fair value hierarchy drive the disclosures that entities need to make about these types of financial instruments. The hierarchy is designed to help users of financial statements understand how the entity's fair value measurement was determined and the reliability of any estimates or assumptions used. The hierarchy identifies which assumptions, estimates and other inputs are observable in the market (and are therefore more objective), versus those that are not observable in the market (and are therefore more subjective).



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

Introducing the new fair value hierarchy

Level 1. Quoted prices in active markets for identical assets and liabilities.

The inputs (that is, the assumptions and other estimates) used to measure the financial instrument are readily available in the market and are typically obtainable from multiple sources. For example, equities listed on the stock exchange, government bonds that are actively traded, and listed corporate bonds.

Level 2. Fair values based on observable market data.

All significant inputs used to measure the financial instrument are observable in the market either directly (i.e., as prices) or indirectly (i.e., derived from prices). These inputs must be observable for substantially the full term of the financial instrument. For example, unlisted corporate bonds where a market credit rating is available and government bonds that are not actively traded.

Level 3. Fair values based on market data that are not observable in the market.

The inputs used to measure the financial instrument are not based on observable market data. For example, some long-dated interest rate options, long-dated foreign currency derivatives, and unlisted equity investments where the valuation is determined using management's financial forecasts.

In addition to disclosing the level of the financial instrument in the fair value hierarchy, entities must disclose the following information for each class of financial instruments:

- i. Any significant transfers between Level 1 and Level 2 of the hierarchy and the reasons for those transfers;
- ii. Their accounting policy for recognising the difference (if any) at transaction date between the transaction price and the fair value of the financial instrument using a valuation technique ("day one profit or loss"); and
- iii. Where fair value measurements are within the Level 3 category of the hierarchy:
 - a reconciliation from the beginning balances to the end balances.
 - if the fair value would change significantly by using alternative reasonably possible assumptions, entities must disclose that fact, the effect of those changes, and how the effect was calculated.
 - key assumptions and estimates (e.g., relating to pre-payment rates, interest rates, or discount rates).

The amendments to IFRS 7 also enhance the disclosures required about entities' liquidity risk, primarily in relation to any derivative instruments, financial guarantees, and financial assets the entity holds.

An opportunity in disguise for management

The amendments give management the opportunity to evaluate and refine their fair value measures and techniques. We expect the new disclosure requirements to be a key area of focus for those charged with governance, such as the audit committee and the board, so it's imperative that management has a clear understanding of the impacts of their fair value measures and assumptions on their business.



Impairments – a long and winding road

The economic storm of the last 18 months has impacted many aspects of financial reporting, not least impairments of non-financial assets. Some common themes have emerged from the many impairment queries which were directed to the PricewaterhouseCoopers' Accounting Consulting Services team.

Serial impairment charges

A number of companies have taken more than one impairment charge as the downturn has bitten. One company was updating impairment calculations on a monthly basis a year ago as the news from their customers became steadily worse. Impairment testing at a date before the year-end can save time; however, in a downturn, there is an increased risk of a trigger event for a test arising between the date of the impairment test and the year-end. If there is a trigger, the test needs to be updated, even if the indicators are conflicting.

Quality of assumptions

The output of impairment tests depends on the inputs. This is not a science but the assumptions made need to be reasonable and supportable, and should be based on expectations not aspirations. In addition, they should not be made in isolation but should be consistent with each other. For example, higher revenue growth rates (such as in some high technology businesses) should usually be accompanied by higher discount rates, reflecting the increased risk that the higher revenue growth will not appear.

Aggressive revenue targets that have been accompanied by low discount rates will produce a high present value in a discounted cash flow. The final check – to review the result produced by the model against other market data, including typical price/earnings ratio's of comparable entities – should highlight where the misstatement risk is high. Performing this final step is vital.

A classic misstatement error in the last 12 months has been to assume that a fall in short-term risk-free rates

will feed through to lower discount rates for impairment testing. Short-term, risk-free rates have fallen sharply, but longer-term risk-free interest rates have not fallen nearly as far. In addition, risk premia and credit spreads have increased dramatically. Discount rates produced using a WACC model have therefore been higher in the current year than previously. This makes sense, as the discount rate is trying to measure the risk inherent in the assets being tested for impairment. The global recession has increased the risk; discount rates therefore go up.

Value in use or fair value?

Management should be clear whether it is doing a value-in-use impairment test or one based on fair value less costs to sell. The recoverable-amount calculation method chosen from these two options should be the one that gives the highest recoverable amount and therefore the lowest impairment. A different calculation method will lead to a different test; forecast cash flows, discount rates and even the assets/liabilities being tested will all be different depending on the test method chosen.

A common error is selecting a value-in-use test but not adjusting the cash flows to strip out the costs and benefits of re-organisations and enhancement capital expenditure. Another common problem is describing the test as a value-in-use test but using post-tax cash flows discounted at a post-tax rate. Value in use is explicitly pre-tax in the standard, so the calculation of the impairment charge needs to be performed at a pre-tax level. Fair value less costs to sell is a post-tax test, performed using post-tax cash flows and comparing with post-tax assets.

Onerous disclosure requirements

Another key lesson from the last 12 months is that the disclosure requirements are onerous and take time to address. There has been a substantial increase in the volume of disclosures, especially the sensitivity analysis. Sensitivity analysis is required where goodwill or indefinite-lived intangible assets are subject to testing. It is also required where there is not much headroom in the recoverable amount, such that a reasonably possible



change in any key assumption would remove what headroom exists. Required disclosures include describing the cash-generating unit, quantifying the headroom and the key assumptions and by how much they would have to change to remove the headroom. There has been a substantial increase in regulatory scrutiny in this area.

Is this the end of the impairment era?

Probably not. There will be more impairments and more near misses (with associated disclosure requirements) for many reasons. The downturn may not be over yet, and some sectors are yet to see the real effects given they lag behind other parts of the economy. There are mixed indicators of recovery. Management may have made optimistic assumptions about the timing of the economic recovery and how long it may take the rising tide to affect their cash flows. Avoiding an impairment in previous periods with optimistic assumptions may elevate the risk of impairments in the future if the recovery takes longer to occur or does not have the benefits expected for the company.

The assumptions made in impairment calculations continue to need a sceptical eye. Unduly pessimistic assumptions in order to take a 'big bath' charge are also not in accordance with the standards. However, no management team wants to be the last company in their market and industry to take impairment charges.

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