Impairment of Assets

Supervision of Financial Reporting

October 2012

Contents

The Netherlands Authority for the Financial Markets

The AFM promotes fair and transparent financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumers' and the business sector's confidence in the financial markets, both in the Netherlands and abroad. In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

1 Executive Summary

Due to the deteriorated economic circumstances and outlook, the AFM has conducted a thematic review on 'Impairment of Assets'. The AFM's findings as a result of the review are as follows:

- **Impairment losses have increased sharply, but investors appear to be pricing in even more impairment losses to come;**
- **The majority of the impairment losses occurred in the fourth quarter;**
- **The disclosures of impairment losses and the calculation of the value in use are cursory in nature;**
- **There is room for improvement in the sensitivity analysis to assist opinion-forming by investors.**

Impairment losses increase sharply

The thematic review 'Impairment of Assets' (IAS 36) reveals that in both nature and size, many more impairment losses (goodwill and intangible non-current assets) were recognised in 2011, when compared to 2010. Of the 40 companies selected, 20 reported an impairment loss in their financial statements, and 13 of these were material. The companies selected recognised €3.361 billion in impairment losses in 2011 compared to €137 million in 2010. This corresponds to the expectation expressed by the AFM when announcing its decision to conduct this thematic review, and reflects the worsening economic situation in 2011.

Investors appear to be pricing in even more impairment losses to come

It is notable that 11 out of 27 companies that did not report a material impairment loss have a market capitalisation that is lower than the carrying amount of their net assets. Investors in these cases appear to be already pricing in an impairment loss, while the companies themselves have not (or not yet) considered recognition of an impairment to be necessary. The reason for this is clearly related – in part – to a difference in estimates and assumptions, but it is also definitely due to a lack of discipline in exercising sufficient rigour, in practice. This is a development that we will continue to follow closely, and also a prominent issue internationally.

Many impairment losses in the fourth quarter

Looking at the timing on which the impairment loss is recognised, it is notable that a majority (12 out of 20) of the companies report the loss in the fourth quarter, although indications that a loss could occur were already present earlier. In view of the uncertain market conditions, it is important that investors are informed promptly. If such indication exists, companies should carry out an impairment test during the year, and not wait until the last quarter.

Cursory disclosure of impairment losses

Companies generally disclose an individual material impairment loss in accordance with the requirements of IAS 36. However, the important information on the reasons for an individual impairment loss is, unfortunately, given only cursory attention. The reason cited is mostly restricted to a statement that the impairment loss is due to the economic crisis. In our opinion, information on the specific reasons for impairment losses is useful to investors. This applies all the more when relatively large acquisitions have been effected, as occurred recently.

Disclosure of the calculation of value in use is too limited

The majority of the companies determine the recoverable amount on the basis of the value in use. The disclosures of the calculation of the value in use are in accordance with IAS 36. However, the disclosure of the key assumptions used is limited. Most companies only disclose revenue growth and the discount rate used. Most do not disclose the assumptions regarding earnings growth, even though this assumption is important for investors for determining the cash flow, for instance.

Almost all companies disclose the growth percentages for terminal growth. The percentages that the companies have used are between 0% and 3%. Despite the difficult market conditions, only 2 companies reduced their growth percentage, and 2 increased the maximum growth percentage. Given the deteriorated market conditions, the AFM would have expected more reductions.

Sensitivity analysis: room for improvement, and an important item

A comprehensive sensitivity analysis gives the user of the financial reporting a good understanding of the factors involved in the determination of the recoverable amount and the decision as to whether recognition of an impairment loss is necessary or not. Unfortunately, the majority of the companies reviewed did not include a disclosure of the ‘reasonably’ possible effects of changes to the assumptions used to establish the recoverable amount of a cash-generating unit. Only 5 out of 40 companies state the amount by which the fair value exceeds the carrying amount and the amount of the change that would make recognition of an impairment loss necessary. A large number of companies explicitly state in their financial statements that a sensitivity analysis is not applicable in their case. It is notable in this respect that a majority (8 out of 11) of the companies whose market capitalisation is less than their equity did not consider it necessary to include a sensitivity analysis, while investors are clearly already taking account of scenarios in which an impairment loss will have to be recognised. We want to highlight that in the current period of uncertainty in the markets, disclosures are not just a compliance exercise; they are an important means of communication from the company’s management to investors.

Rationale: the deteriorating market conditions

The rationale for this thematic review is the further deterioration in the economy and the economic outlook, meaning that there is a possibility that impairment losses will have to be recognised. The deteriorating market conditions are affecting the results of many companies (for example, through lower sales and lower margins), which is an indication of potential impairment of assets. Share prices have also fallen sharply, so that in some cases the carrying amount of the net assets is higher than the company's market capitalisation. This is an important indication that impairment may have occurred.

Population: 40 companies for which goodwill is significant

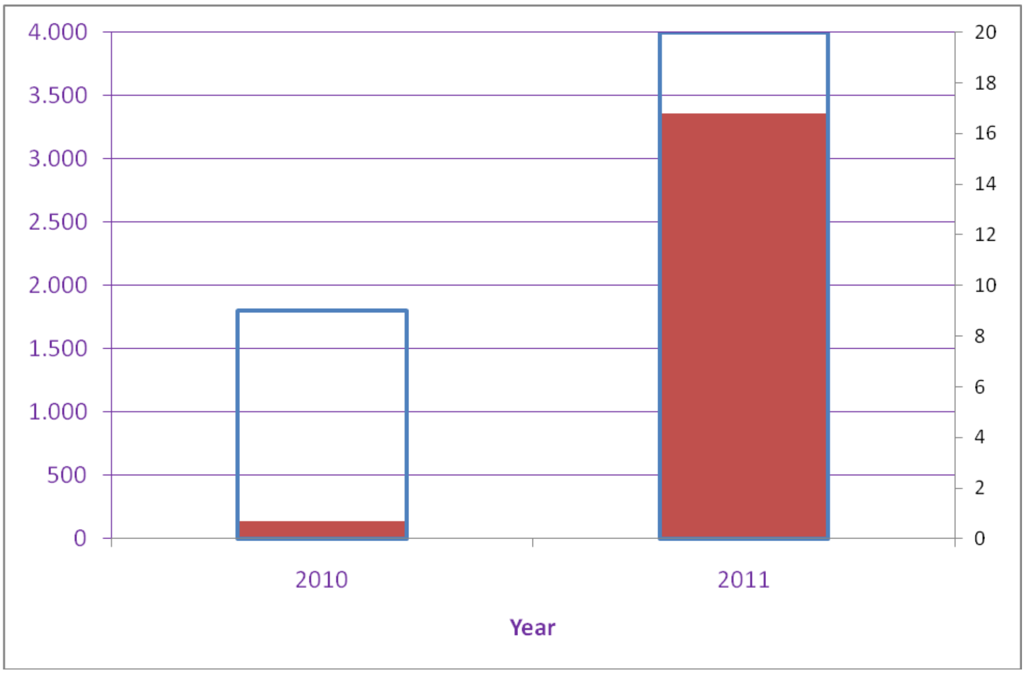
The thematic review was carried out using the 2011 financial reporting of Dutch companies subject to supervision whose shares were admitted to trading on Euronext Amsterdam as at 31 December 2011. The selection criterion we used was the ratio of goodwill plus intangible non-current assets divided by equity. For the 40 companies selected, this ratio is more than 50%. Our thematic review involves 40 companies which report a total of €99 billion in goodwill and intangible non-current assets in their statements of financial position.

2 Key review results

2.1 Impairment losses increased sharply

There was a sharp increase in the impairment losses recognised in the 2011 reporting year compared to 2010 (see figure 1). Half of the companies we selected reported one or more impairment losses in their financial statements.

Figure 1: Number of financial statements with impairment losses (in blue) observed in 2010 and 2011 and the amount of the impairment loss (in red)



In the majority of the cases (13), the impairment loss was material. The companies selected recognised €3.361 billion in impairment losses in 2011 compared to €137 million in 2010. The increase in losses is due to the deteriorated economic conditions.

2.2 Investors appear to be pricing in even more impairment losses to come

In cases where the carrying amount of the net assets is more than the market capitalisation, investors appear to be already pricing in an impairment loss, although the companies concerned do not (or not yet) see a need for this.

IAS 36.12 states: “In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications: ….(d) the carrying amount of the net assets of the entity is more than its market capitalisation.”

In our review therefore, we focused on the companies that did not recognise an impairment loss although there were indications that an impairment loss may have occurred. 11 of the 26 companies that did not report a material impairment loss have a market capitalisation that is lower than the carrying amount of their net assets. Investors in these cases appear to be already pricing in an impairment loss, while the companies themselves have not (or not yet) considered recognition of an impairment to be necessary. The investors, therefore, seem to be less optimistic regarding projected future cash flows than the management. The reason for this is clearly related – in part – to a difference in estimates and assumptions, but it is also definitely due to a lack of discipline in exercising sufficient rigour, in practice. The AFM will obviously follow these companies closely, and initiate a further investigation if necessary. This issue is also on the international agenda, as evidenced by the statement from the Chairman of the IASB in June 2012:

"The acquired goodwill is subsequently subject to an annual impairment test. In practice, these impairment tests do not always seem to be done with sufficient rigour. Often, share prices reflect the impairment before the company records it on the balance sheet. In other words, the impairment test comes too late. All in all, it might be a good idea if we took another look at goodwill in the context of the post-implementation review of IFRS 3 Business Combinations."

2.3 Many impairment losses in the fourth quarter

In view of the uncertain market conditions, it is important that investors are informed promptly in case of impairment losses. If such indication exists, companies should therefore carry out an impairment test during the year and not wait until the last quarter. It is notable that a majority (12 out of 20) of the companies recognised the impairment loss in the fourth quarter although indications of a potential loss were present at an earlier stage. In the cases where the impairment loss was recognised at an earlier stage, this appears to have been related to a change of management, a change of strategy or compelling expectations in the market that an impairment loss needed to be recognised. The AFM urges companies to carry out an impairment test during the year if such indication exists.

2.4 Cursory disclosure of impairment losses

Information on the specific reasons for impairment losses is useful to investors. This is certainly the case if acquisitions have recently been effected. For investors, it is useful to know which assumptions by the management, that played a part in the decision to effect the acquisition, did not turn out to be correct, and the effects of this on the company's financial position and performance.

IAS 36.130 states that a company must provide detailed disclosures in the event of recognition or reversal of a material impairment loss during the period. The 13 companies that recognised a material impairment loss are, in general, in compliance with the requirements of IAS 36.130. In most cases, they state the line in the income statement in which the loss is recognised. They also disclose the asset and/or cash-generating unit to which the impairment loss relates. However, the important information on the reasons for an individual impairment loss is, unfortunately, given only cursory attention. The reason cited is mostly restricted to a statement that the impairment loss is due to the economic crisis, with no reference to company-specific circumstances.

The AFM takes the view that the disclosure must provide relevant information for investors, including information on the specific reasons why the impairment losses have occurred.

2.5 Disclosure of accounting policies is frequently boilerplate language

All companies disclosed an accounting policy for the determination of impairment of assets. IAS 1.108 states that the company must disclose its key accounting policies.
Most companies use a generic text for the description of their accounting policy for the determination of impairment of assets. The formulation of the accounting policy appears in many cases to be a direct quotation from IAS 36 and contains little or no company-specific information. There is extensive use of boilerplate language.
We take the view that stating accounting policies for the impairment of assets in only generic terms means that important information is not provided to the users of the financial statements.

2.6 A majority determine the recoverable amount on the basis of value in use

Nearly all companies disclose how the recoverable amount is determined. Both IAS 36.130(e) and IAS 36.134(c) require that it must be stated whether the recoverable amount of the asset is its fair value less costs of disposal (fair value) or its value in use.
The vast majority of the companies (36) determine the recoverable amount on the basis of value in use. Only 2 companies did not explicitly state whether the recoverable amount was determined on the basis of fair value or on value in use. In these cases, we were able to infer from the information in the financial reporting that these companies had determined the recoverable amount on the basis of value in use.

2.6.1 Disclosure of calculation of value in use is too limited

The disclosures relating to the key assumptions used to determine value in use contain useful information for investors. We want to highlight that especially in the current period of uncertainty in the markets, disclosures are not just a compliance exercise, they are an important means of communication from the company's management to investors.

IAS 36.130 and IAS 36.134 state that the company must explain how it determines value in use. The disclosures on the calculation of value in use that we have seen are limited, but are in accordance with IAS 36. Companies state the period over which cash flows are estimated. The majority use a period of five years. If a different period is chosen, this is disclosed separately. The disclosure of the key assumptions is limited (33 companies state the discount rate and 25 revenue growth). Only 7 companies disclose earnings growth/profitability, even though this assumption is very important to investors for determining the future cash flow. In our review, we encountered the following disclosure of the key assumptions that in our opinion provides information that is useful to investors.

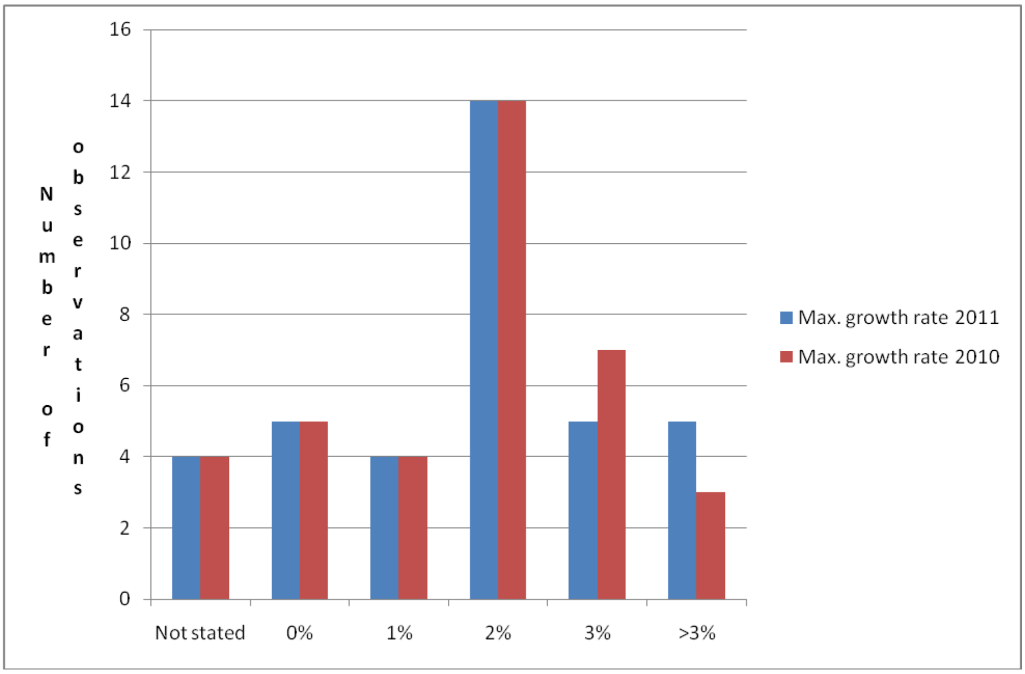
Table 1: best practice, disclosure of key assumptions per cash-generating unit

CGU	**Discount rate**		**Terminal growth**		**EBIT growth**		**Sales growth**	
	2010	***2011***	***2010***	***2011***	***2010***	***2011***	***2010***	***2011***
A	8.1%	9.3%	2.0%	2.0%	12.3%	9.3%	2.1%	1.8%
B	9.8%	9.1%	2.0%	2.0%	6.5%	8.3%	1.5%	2.3%
C	11.6%	11.3%	2.0%	2.0%	4.3%	3.9%	1.7%	1.6%
D	10.8%	9.6%	2.0%	2.0%	8.5%	13.9%	2.0%	3.2%

As can be seen from the table above, the assumption relating to EBIT growth is the main determining factor for the projected cash flow for investors. The AFM urges companies to include relevant disclosures regarding the key assumptions in their financial reporting.

Almost all companies disclose the growth percentages for terminal growth, most of which lie between 0% and 3%. Only 1 company uses a negative percentage. Despite the difficult market conditions, only 2 companies reduced their growth percentage, and 2 increased the maximum growth percentage. Given the deteriorated market conditions, the AFM would have expected more reductions.

Figure 2: maximum growth rates



2.6.2 Disclosure of determination of recoverable amount on basis of fair value

IAS 36.130 and IAS 36.134 state that the company must explain how it determines value in use. Only a few companies (4) determine the recoverable amount of a cash-generating unit on the basis of fair value. In the majority of cases, the fair value of the cash-generating unit is determined on the basis of the present value of future cash flows. The disclosures provided by the companies seem to correspond with those provided for the determination of value in use. We wish to stress that when determining the fair value of a cash-generating unit on the basis of the present value of future cash flows, companies should base this on the assumptions that are known in the market, and not on the basis of management estimates that are not known in the market.

2.7 Sensitivity analysis: room for improvement, and an important item

Full application of the provisions of IAS 36.134(f) gives investors a good understanding of the factors involved in the determination of the recoverable amount of a cash-generating unit and the decision as to whether recognition of an impairment loss is necessary or not. Companies should therefore provide certain disclosures if a ‘reasonably’ possible change in a key assumption would reduce the recoverable amount of a cash-generating unit to such an extent that an impairment loss would occur. IAS 36.134(f) requires that the effect of changes in the assumptions used for the calculation of the recoverable amount of a cash-generating unit must be disclosed.

This disclosure appears only rarely among the companies we have reviewed. In only 5 cases is a sensitivity analysis provided that states the amount by which the fair value exceeds the carrying amount, and the amount of the change that would make recognition of an impairment loss necessary. A large number of companies (22) explicitly state in their financial statements that a sensitivity analysis is not applicable in their case. It is notable in this respect that a majority (8 out of 11) of the companies whose market capitalisation is less than their equity did not consider it necessary to include a sensitivity analysis.

The AFM concludes that there is room for improvement in the disclosure of the effects of changes in the assumptions that could lead to an impairment loss. As stated above, full application of the provisions of IAS 36.134(f) gives investors a good understanding of the factors involved in the determination of the recoverable amount of a cash-generating unit and the decision as to whether recognition of an impairment loss is necessary or not. We want to highlight that especially in the current period of uncertainty in the markets, disclosures are not just a compliance exercise; they are an important means of communication from the company’s management to investors.

In conclusion, we give an example of a sensitivity analysis that we encountered in financial statements provided by a European company that, in our opinion, provides information that is useful to investors.

“A sensitivity analysis on the key assumptions in the impairment testing is presented below. The allowed change represents the percentage points by which the value assigned to the key assumption as applied in the expected long-term rate can change, all other things being equal, before the unit’s recoverable amount equals its carrying amount.”

	2011			
	Growth		Discount rate, net of tax	
	Applied expected long term rate	Allowed decrease	Applied rate	Allowed increase
France	2.5%	0.0%	9.0%	0.0%
United Kingdom	2.5%	>3.0%	8.5%	>3.0%
Finland	2.0%	2.9%	8.7%	3.0%
Norway	2.0%	>3.0%	9.6%	>3.0%
Australia	3.0%	>3.0%	10.5%	>3.0%
Denmark	2.0%	0.4%	8.9%	0.3%
Netherlands	2.0%	0.4%	9.2%	0.3%
Belgium	2.5%	0.3%	10.2%	0.2%
Switzerland	2.0%	>3.0%	6.9%	>3.0%
Spain	2.5%	0.8%	10.4%	0.6%

	2010			
	Growth		Discount rate, net of tax	
	Applied expected long term rate	Allowed decrease	Applied rate	Allowed increase
France	3.0%	0.0%	8.5%	0.0%
United Kingdom	3.0%	>3.0%	9.0%	>3.0%
Finland	3.0%	2.7%	8.8%	2.9%
Norway	3.0%	>3.0%	9.8%	>3.0%
Australia	3.0%	2.7%	10.7%	2.8%
Denmark	3.0%	2.7%	9.3%	2.9%
Netherlands	3.0%	3.0%	9.3%	2.4%
Belgium	3.0%	1.5%	9.6%	1.2%
Spain	3.0%	0.0%	11.0%	0.0%
Ireland	3.0%	0.0%	11.1%	0.0%
Greece	3.0%	0.1%	11.1%	0.1%

3 Rationale, objectives and population

Rationale: deteriorated market conditions that could lead to impairments

The rationale for this thematic review is the further deterioration in the economy and the economic outlook, meaning that there is a possibility that impairment losses will have to be recognised. After a cautious recovery in 2010 and the beginning of 2011, the economy weakened significantly in the second half of 2011. The credit crisis led to much uncertainty, and large parts of Europe entered a recession. This is affecting the results of many companies (for example, through lower sales and lower margins), which is an indication of potential impairment of assets. Share prices have also fallen significantly on average in the past few years, leading to a situation in which the carrying amount of net assets for some companies is higher than their market capitalisation, which is also an indication that impairment may have occurred. These facts and circumstances were involved in our decision to conduct a thematic review based on IAS 36.

Objectives

The objective of thematic review IAS 36 is to assess and report on the application of IAS 36, and thereby to encourage companies to improve the quality of their financial reporting.

The key objectives of the review were:

1. Assessment of the quality of the disclosure: are the requirements of IAS 36 met? Also: what is the nature of the disclosures (are they specific to the business or generic)? And: what key assumptions are disclosed?
2. Assessment of the quality of the sensitivity analysis: to establish whether the quality is adequate to provide the information needed by investors.

Population: 40 companies

The thematic review was carried out using the 2011 financial reporting of Dutch companies subject to supervision whose shares were admitted to trading on Euronext Amsterdam as at 31 December 2011. The selection criterion we used was the ratio of goodwill plus intangible non-current assets divided by equity. For the 40 companies selected, this ratio is more than 50%. The companies concerned include large-cap, mid-cap and small-cap businesses. Our thematic review involves 40 companies which report a total of €99 billion in goodwill and intangible non-current assets in their statements of financial position.

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Amsterdam, October 2012