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# Accounting for asset impairment:

## A test for IFRS compliance across Europe

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# Introduction

### The IFRS revolution: some early evidence

- Improved reporting quality
- Lower cost of equity and higher liquidity for "serious" adopters
- Increased institutional investment
- Greater cross-country comparability

### Lessons from accounting research

- Variation in reporting practices persists; some pre-IFRS differences survive
- Uneven IFRS compliance
- When compliance is weak, benefits are not expected to follow
- Important role of institutional regimes and firm-specific attributes in shaping incentives for compliance

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# Introduction

### Relevance of asset write-downs: why now?

- Financial and economic instabilities
- Events surrounding the crisis may have triggered write-downs
- Importance of assumptions and estimates underlying impairments
- IFRS preparers in Europe are likely to continue to face impaired assets

### Persistent economic uncertainty: A recipe for impairment

- Assets: probable future economic benefits (e.g., future cash flows)
- Downward revisions to forecasts of future cash flows and growth
- Upward revisions to projected discount rates (risk)
- Reduced likelihood that carrying amounts will be recovered
- Revised assumptions and estimates following the crisis



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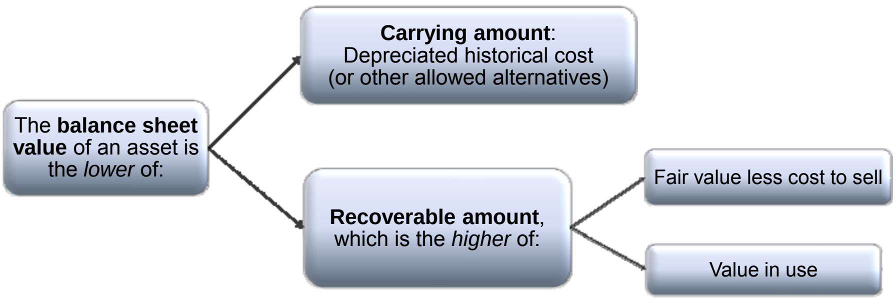
# Measuring asset impairment – IAS 36



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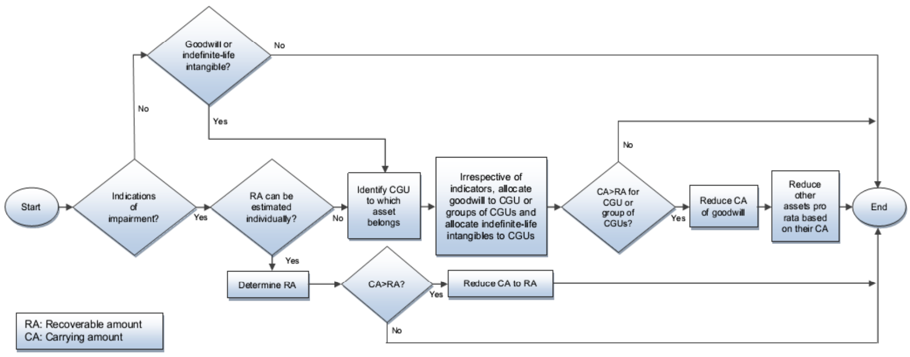
# Asset impairment testing – IAS 36




See: (Ernst & Young, 2011)



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# Overview of the research

## What we do in this study

### An empirical evaluation of “asymmetric timeliness”

- Timeliness of IFRS impairments across Europe (2006-2011)
- Speed at which economic losses are captured by impairments
- Cross-country variation in the timeliness of asset write-downs
- A sample of impairment-intensive (impairments as a % of total assets) firms

### A survey of impairment reporting practices

- Compliance with IFRS impairment reporting requirements in recent published annual accounts (2010-2011)
- Role of country-level institutional and regulatory regimes and firm-specific factors
- Unexplored role of effort and managerial judgement in shaping compliance

# Overview of the research

## Institutional and regulatory diversity

- Presence of "institutional bundles" around the world
  - **Cluster 1 countries**: Outsider economies with strong outside protection and rule enforcement regimes
  - **Cluster 2 countries**: Insider economies with (relatively) stronger rule enforcement regimes
  - **Cluster 3 countries**: Insider economies with weaker regulatory scrutiny and rule enforcement regimes

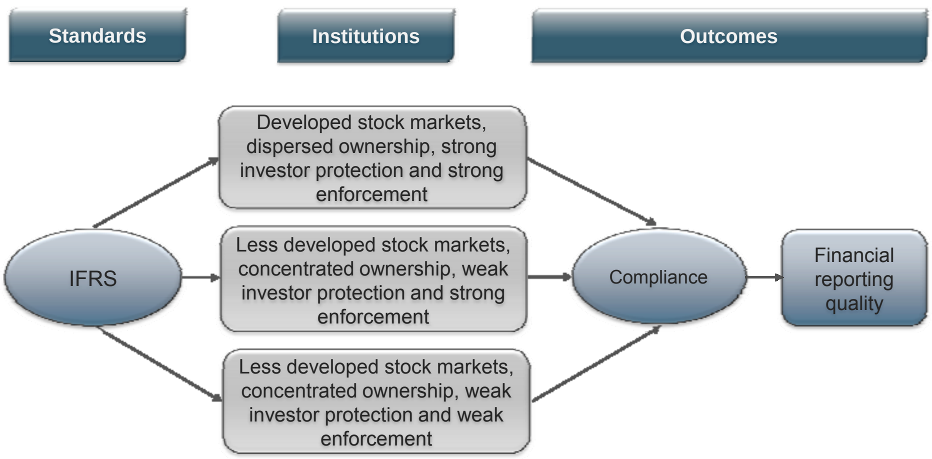
## Role of institutional differences

- Variations in timely loss recognition across institutional country-clusters
- Differences in IFRS compliance for impairments of non-current non-financial assets (PP&E, intangible assets and goodwill)





# Institutional and regulatory regimes



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# Institutional clusters in Europe

| Cluster 1 | Cluster 2 | Cluster 3 |
|---|---|---|
| Large, developed stock markets<br>Dispersed ownership<br>Strong investor protection<br>Strong enforcement | Less developed stock markets<br>Concentrated ownership<br>Weak investor protection<br>Strong enforcement | Less developed stock markets<br>Concentrated ownership<br>Weak investor protection<br>Weak enforcement |
| Ireland | Austria | Czech Republic* |
| United Kingdom | Belgium | Estonia* |
| | Denmark | Greece |
| | Finland | Hungary* |
| | France | Italy |
| | Germany | Lithuania* |
| | Luxembourg | Poland* |
| | Netherlands | Portugal |
| | Norway | Romania* |
| | Spain | Slovakia* |
| | Sweden | Slovenia* |
| | Switzerland | |

* Countries not covered in earlier classifications

See: (Leuz et al., 2003; Leuz, 2010)



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# Timeliness of impairments

- Asymmetric timeliness: manifestation of conditional conservatism
- Evidence from 4,474 listed companies (2006-2011) support the role of institutions in shaping timely loss recognition across all three asset classes

| AT across country-clusters (2006-2011) | Firms | Earnings | PP&E impairment | Intangible asset impairment | Goodwill impairment |
|---|---|---|---|---|---|
| All countries | 4,474 | 31.7% | 5.7% | 7.4% | 17.8% |
| Cluster 1 | 1,203 | 35.1% | 9.4% | 9.2% | 20.7% |
| Cluster 2 | 2,321 | 32.9% | 4.4% | 5.3% | 12.9% |
| Cluster 3 | 950 | 18.6% | 1.2% | 0.0% | 5.9% |

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# Survey of impairment reporting practices

## IFRS compliance behaviour

### How we document compliance levels

- Survey based on IFRS impairment disclosures (99 items across asset groups)
- Unweighted and partial indices, overall and for each asset class
- Sample of 324 impairment-intensive companies in 2010-2011

### Some highlights from our findings

- Major variations and limited cases of full compliance across the asset classes
- Median compliance ranges from 77.2% (intangible assets) to 85.6% (PP&E)
- Positive association between impairment intensity and compliance



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# Survey of impairment reporting practices

## Observations from selected disclosure areas

### Accounting policies and judgements

- High levels of compliance across Europe
- Boilerplate disclosures, possibility of mere “box-ticking”

### Estimation uncertainty and changes to past assumptions

- Uncertainty: root of subjectivity in impairment measurements
- Heightened relevance in times of economic uncertainty
- Limited disclosure on changes to or the continued relevance of assumptions

### Sensitivity of carrying amounts

- Limited disclosure (country-level median: 56.8%) may have implications for the relevance of goodwill information
- Disclosures are important in shaping users’ views on reliability

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# Survey of impairment reporting practices

## Observations from selected disclosure areas

### Triggering events

- Justification for asset write-offs is critical
- Lack of adequate transparency adds to uncertainty (e.g., only 71% in PP&E)

### Basis for recoverable amount (VIU or FVLCD)

- VIU is the prevalent measurement method
- Many cases where the basis is not specified (e.g., 38% in intangible assets)
- Selected bases impact balance sheet positions

### Highly aggregated disclosures for segment results

- Impairments are often aggregated with segment depreciation and amortisation
- Potential for reduced relevance of segment information



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# Survey of impairment reporting practices

## Observations from selected disclosure areas

### Disclosure of impaired assets within operating segments

- Opacity of disclosures on “impaired” assets per segment (e.g., country-level median score for the intangibles sample is as low as 29.2%)

### CGU description and allocation of goodwill to CGUs

- Higher disclosure scores (e.g., description: 74%; GW per CGU: 85%)
- Uneven disclosures on *justification* for allocation decisions

### Cash flow projections, growth and discount rates

- Variation in disclosures on assumptions about projections and selected rates
  - *Projection periods*: single versus multiple forecast period
  - *Growth rates*: single versus multiple growth rates
  - *Discount rate*: WACC used evenly across CGUs with different risk profiles

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# Drivers of impairment reporting practices

## Institutions and firm-level attributes

### Compliance differences across country-clusters

- Higher compliance scores in cluster 1 countries
- No major difference in compliance between cluster 2 and cluster 3 countries

### Institutions and firm-specific features

- Range of firm-level attributes considered
- Results for our sample suggest that disclosure quality is higher when:
    - firms have Big 4 auditors;
    - are larger (size measured based on total assets)
    - have higher leverage (measured based on scaled total debt)
    - are more impairment-intensive
    - are operating in the oil and gas industry



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# Role of effort and judgement

## A general effort-based classification of IFRS disclosures

### High-effort versus low-effort disclosures

- Discretion and judgement varies across disclosures
- Some require high effort (e.g., annual sensitivity analyses) while other do not (e.g., accounting policy on depreciation)
- Potential for variation in compliance across the two partitions

### Results

- Significant differences in the two sets of disclosures across all asset classes
- Cost and effort associated with disclosures adversely influence the quality of information provided by preparers
- High compliance with low-effort requirements is masking low compliance with high-effort requirements

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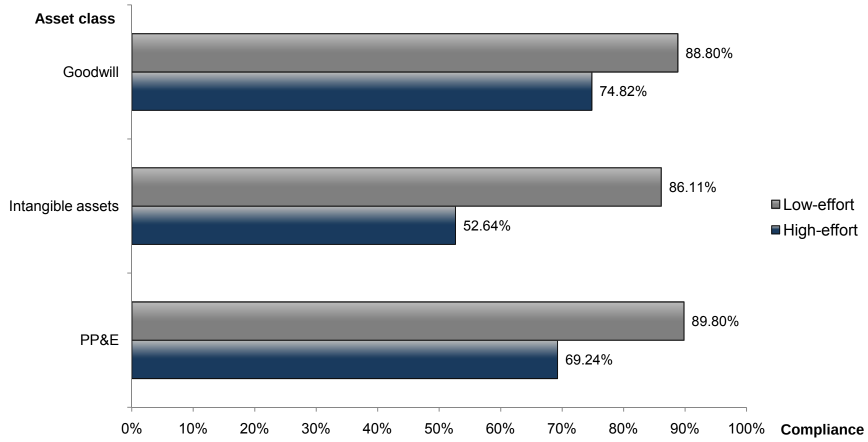
# Role of effort and judgement



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# Summary and conclusion

**Uneven application of IFRS for impairment reporting across Europe**

- Variations in timeliness and compliance levels across countries and industries

**Role of regulatory and oversight regimes in IFRS application**

- Harmonised standards may not translate into harmonised reporting practices

**IFRS entail major judgements, estimates and assumptions**

- Managerial discretion in making judgements
- Validity of assumptions underlying measurements
- Compliance effort is uneven across requirements; do the benefits of disclosure justify preparers' costs (efforts)?

**High-quality disclosure can reduce uncertainty about measurements**

- Relevant for valuation purposes and to users' economic decisions

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