Determination of net selling price of a cash generating unit incurring losses

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

1. The accounts of a public sector company are audited by the Office of the Principal Director of Commercial Audit & Ex- Officio Member, Audit Board. During the audit of the accounts of the company for the financial year 2004-05, certain differences of opinion had arisen in respect of Accounting Standard (AS) 28, 'Impairment of Assets', issued by the Institute of Chartered Accountants of India. The auditors, however, had cleared the accounts for the year 2004-05, on the commitment made by the company to take opinion from the Expert Advisory Committee of the Institute of Chartered Accountants of India.

2. The querist has stated that the company has mainly three different businesses controlled by three separate business groups as under:

   (i) Business Group (Petroleum) – It is engaged in storage and distribution of high speed diesel, motor spirit (petrol), kerosene oil, naphtha, aviation turbine fuel, etc., and manufacture and marketing of automotive lubes and grease, etc. Turnover of this business group (B.G.) in the financial year 2004-05 was Rs. 13,364 crore. Under the B.G. (Petroleum), there are 3,272 petrol pumps as on 31.03.2005, 17 depot terminals (for storing and distribution of petroleum products), 27 divisional offices, 4 regional offices, one marketing head office at Mumbai and one corporate head office at Kolkata. For budget and MIS reporting purpose, B.G. (Petroleum) as a whole has been considered as a separate unit and budgeted profitability is being prepared for the B.G. (Petroleum) separately.

   For the purpose of accounting, all transactions (cash/bank/journal) at the divisional office level and depot level are consolidated at the concerned region. Except some major adjustments pertaining to margin updation, Government subsidy is being controlled and accounted for at marketing head office for petroleum at Mumbai. Considering 4 regional final accounts and separate final accounts for LPG business, marketing head office for petroleum prepares consolidated final accounts for the petroleum business which is ultimately consolidated at corporate head office at Kolkata along with the final accounts of B.G. (Explosives) and B.G. (Cryogenics).

   Considering various provisions of AS 28 and the industry practice on the issue, the company has considered business group (petroleum) as 'cash generating unit (CGU)' instead of considering each regional offices and LPG business as separate CGUs. Reason being that individual regions and LPG business are not independent of cash inflows from the other assets or group of assets of the B.G. (Petroleum). The statutory auditors of the company and C&AG have agreed to consider the B.G. (Petroleum) as a separate CGU.

   (ii) Business Group (Explosives) – It is engaged in manufacture and marketing of site mixed explosives, re-pumpable bulk emulsion explosives, cartridged explosives, detonating fuses, cast boosters, etc. Turnover of this group in the financial year 2004-05 was Rs. 92 crore. Under B.G. (Explosives), there are 14 manufacturing plants, two marketing offices at Delhi and Nagpur and one divisional

head office at Kolkata. Individual plants are maintaining accounts and making all payments except for majority of the raw material payment which is procured centrally from the divisional head office (DHO) at Kolkata. Sundry creditors for raw material and debtors are also being maintained centrally at divisional head office.

For the purpose of Budget and MIS, overall profitability of the B.G. (Explosives) is being prepared. However, plant-wise profitability is also prepared as per the requirement of the management from time to time. Trial balances of each plant, after getting audited, are sent to DHO for consolidation and preparation of final accounts of B.G (Explosives) which subsequently get consolidated at corporate head office, Kolkata along with B.G. (Cryogenics) and B.G. (Petroleum) accounts. The final accounts get audited at regional level, Mumbai Head office level for B.G. (Petroleum) and at DHO level for B.G. (Cryogenics) and B.G. (Explosives).

Considering various provisions of AS 28, the company has considered the Business Group (Explosives) as a separate 'cash generating unit' (CGU). Reasons being: (a) The sales allocation of principal customer of B.G. (Explosives) is being made from DHO, Kolkata. (b) All the major raw materials are being procured centrally at DHO and then placed with the plants as per the requirements. (c) The overall control of the plants with respect to finance, human resource, marketing issues are being centrally controlled at DHO. The statutory auditors of the company and C&AG have agreed to consider the B.G. (Explosives) as a separate CGU.

(iii) Business Group (Cryogenics) - It is engaged in manufacture and marketing of aluminium cryogenic containers, stainless steel industrial cryovessels, etc. Turnover of this group in the financial year 2004-05 was Rs. 23 crore. Under B.G. (Cryogenics), there is one plant at Nasik and one cryogenics head office at Mumbai. Final accounts of B.G. (Cryogenics) are prepared at Mumbai and finally consolidated at Kolkata corporate office along with B.G. (Petroleum) and B.G. (Explosives) accounts. For the purpose of budget and MIS, overall profitability of the B.G. (Cryogenics) is being prepared. Considering various provisions of AS 28, the company has considered Business Group (Cryogenics) as a separate 'Cash Generating Unit'.

3. According to the querist, as stated above, in line with the various paragraphs of AS 28, the company has identified three cash generating units (CGUs), i.e., B.G. (Petroleum), B.G. (Explosives) and B.G. (Cryogenics). For the purpose of testing the impairment of the three CGUs of the company, while calculating the recoverable amount, *value in use has been considered for B. G. (Petroleum)* as it was possible to forecast the future cash flows for the next 10 years (emphasis supplied by the querist). However, according to the querist, to calculate the recoverable amount of B.G. (Explosives) and B.G. (Cryogenics), assets' net selling price has been considered in line with paragraph 15 of AS 28 as it was not possible to forecast the future cash flows nearest to actual due to volatile conditions in the market. The querist has also mentioned that these two business groups have been suffering losses for the last five years. While calculating the net selling price of the above two business groups, since the company was unable to make reliable estimate of the amount obtainable from the sale of the assets in an arm's length transaction between knowledgeable and willing parties, the company had appointed chartered valuers to arrive at the net realisable value of the assets. On the basis of the valuers' reports, the company had tested the impairment of assets of the B.G. (Explosives) and B.G. (Cryogenics) and found that the carrying amounts of the assets are less than the recoverable amount (net realisable value)

of the assets. Hence, as per the querist, no impairment of assets was warranted.

4. The querist has further stated that while considering the net selling price as recoverable amount of the above two business groups, the company has placed reliance on the following: (a) definition of recoverable amount as per paragraph 4 of AS 28 – since these two business groups are making losses, net selling price of the assets will always be higher than the value in use. (b) paragraph 15 of AS 28, which, inter alia, states that it is not always necessary to determine both assets' net selling price and value in use.

B. Query

5. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

   (a) In the absence of a binding sale agreement in an arm's length transaction, or if the assets are not traded in the active market, or in the absence of the current bid prices of the assets, or if the prices of the most recent transaction are not available,

      (i) Whether the assets can be valued by a chartered valuer for accounting at net selling price/ net realisable value, and

      (ii) If yes, whether such value can be considered for the purpose of testing impairment.

   (b) If a CGU is incurring losses, whether the carrying amount should not be more than its value in use.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised in the query relates to the calculation of impairment loss in case of B.G. (Explosives) and B.G. (Cryogenics). The Committee has, therefore, considered only this issue and has not touched upon any other issue arising from the Facts of the Case, such as, identification of CGUs, testing of impairment in case of B.G. (Petroleum), etc.

7. The Committee notes that the basic objective of providing impairment loss is to ensure that the assets of an enterprise are carried at no more than their recoverable amount. Recoverable amount, according to AS 28, "is the higher of an asset's net selling price and its value in use." Hence, the company has to compare the net selling price and value in use of an asset and the higher of these two, which is the recoverable amount, is then compared with the carrying amount of the asset, and if an asset is carried at more than its recoverable amount, i.e., the asset is impaired, then the impairment loss is recognised.

8. Insofar as the calculation of value in use is concerned, the Committee notes the definition of the term 'value in use', as contained in paragraph 4 of AS 28 and paragraphs 26 to 30 of AS 28, which state as follows:

"Value in use is the 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."

"26. In measuring value in use:

(a) cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence;

(b) cash flow projections should be based on the most recent financial budgets/ forecasts that have been approved by management. Projections based on these budgets/forecasts should cover a maximum period of five years, unless a longer period can be justified; and

(c) cash flow projections beyond the period covered by the most recent bud-

gets/forecasts should be estimated by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used, unless a higher rate can be justified.

27. Detailed, explicit and reliable financial budgets/forecasts of future cash flows for periods longer than five years are generally not available. For this reason, management's estimates of future cash flows are based on the most recent budgets/forecasts for a maximum of five years. Management may use cash flow projections based on financial budgets/ forecasts over a period longer than five years if management is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

28. Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/ forecasts using a growth rate for subsequent years. This rate is steady or declining, unless an increase in the rate matches objective information about patterns over a product or industry lifecycle. If appropriate, the growth rate is zero or negative.

29. Where conditions are very favourable, competitors are likely to enter the market and restrict growth. Therefore, enterprises will have difficulty in exceeding the average historical growth rate over the long term (say, twenty years) for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used.

30. In using information from financial budgets/forecasts, an enterprise considers whether the information reflects reasonable and supportable assumptions and represents management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset."

9. Regarding the determination of net selling price of the two business groups, the Committee notes the definition of the term 'net selling price' as contained in paragraph 4 of AS 28, and paragraphs 16 and 20 to 22 of AS 28, which, state as follows:

"Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal."

"16. It may be possible to determine net selling price, even if an asset is not traded in an active market. However, sometimes it will not be possible to determine net selling price because there is no basis for making a reliable estimate of the amount obtainable from the sale of the asset in an arm's length transaction between knowledgeable and willing parties. In this case, the recoverable amount of the asset may be taken to be its value in use."

"20. The best evidence of an asset's net selling price is a price in a binding sale agreement in an arm's length transaction, adjusted for incremental costs that would be directly attributable to the disposal of the asset.

21. If there is no binding sale agreement but an asset is traded in an active market, net selling price is the asset's market price less the costs of disposal. The appropriate market price is usually the current bid price. When current bid prices are unavailable, the price of the most recent transaction may provide a basis from which to estimate net selling price, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the estimate is made.

22. If there is no binding sale agreement or active market for an asset, net selling price is based on the best information available to reflect the amount that an enterprise could obtain, at the balance sheet date, for the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal. In determining this amount, an enterprise considers the outcome of recent transactions for similar assets within the same industry. Net selling price does not reflect a forced sale, unless management is compelled to sell immediately."

10. The Committee notes from the above that while AS 28 does not exempt any enterprise from calculating value in use under any condition, it exempts calculation of net selling price under paragraph 16 reproduced above, where net selling price cannot be arrived at in accordance with the requirements of the Standard. The Standard does not contemplate that in case the net selling price cannot be arrived at as per its requirements, such a price can be arrived at on the basis of the valuation made by a chartered valuer. The said paragraph provides that in such a case the enterprise should, instead, use the value in use. Thus, in the view of the Committee, the company should compute its value in use even though there are volatile conditions in the market, on the basis of the reasonable projections supported by the existing conditions and assumptions over the remaining useful life of the asset as stated in paragraphs 26 to 30 of AS 28. The Committee does not agree with the conclusion given by the querist that in case a CGU is incurring losses, its value in use will always be lower than that of its net selling price. In any case, as stated in paragraph 16 of AS 28, in case the net selling price cannot be computed, the value in use is to be considered by the company. The underlying reason for this requirement is that the fixed assets are held by the company for use in the business rather than for the purpose of their sale. Thus, computation of value in use is paramount.

D. Opinion

11. The Committee is of the following opinion on the issues raised in paragraph 5 above:

    (a) In the absence of a binding sale agreement in an arm's length transaction, or if the assets are not traded in the active market, or in the absence of the current bid prices of the assets, or if the prices of the most recent transaction are not available,

        (i) the values provided by a chartered valuer can not form basis for determining the net selling price/net realisable value of the assets.

        (ii) No, such value can also not be considered for the purpose of testing impairment.

    (b) For the purpose of testing impairment, the carrying amount has to be compared with the recoverable amount (higher of an asset's net selling price and its value in use). In case net selling price cannot be determined in accordance with principles of AS 28, value in use may be taken as recoverable amount, which then should be compared with the carrying amount of the asset. In such a case, carrying amount of the asset should not be more than its value in use, irrespective of the fact that CGU is incurring losses.

Notes:

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty four volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.