Chapter 18
How Czech Companies Comply with IAS 36 Disclosure Requirements

Pavel Huňáček

Abstract This article examines the extent to which the disclosure requirements of IAS 36 Impairment of Assets are fulfilled. Apart from the mandatory disclosure, the analysis also includes an assessment of the potential impact on market liquidity and investment decisions of mainly smaller investors. The analysed data relate to publicly traded companies on the Prague Stock Exchange during the period 2015–2017 and cover impairment information on goodwill, property, plant, equipment and investments in subsidiaries. The results of the investigation confirmed the continuing historically observed non-compliance with information obligations and identified this deficiency as one of the causes of the underdevelopment of the securities market.

Key words IAS 36 · Impairment of assets · Prague Stock Exchange

18.1 Introduction

International Accounting Standard (IAS) 36 Impairment of Assets was accepted by the International Accounting Standards Board (IASB) in April 2001. However, it was created already in June 1998 by the International Accounting Standards Committee (IASC) and revised several times over the years. In 2004, intangible assets were added. It was revised, and several amendments were integrated into it in 2008, 2009 and 2013. The principle of impairment is to ensure that assets are not shown in the balance sheet in excess of the recoverable amount (IASB, 2013).

The disclosure of quality, transparent and comparable information is one of the several main objectives of financial statements prepared in accordance with International Financial Reporting Standards (hereinafter "IFRS" or "Standards"). Financial statements under these Standards have been required for companies that issue securities on the regulated capital markets of the European Union since 2005.

P. Huňáček (✉)
Department of Corporate Finance, Prague University of Economics and Business, Prague, Czech Republic
e-mail: xmasp00@vse.cz

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They are primarily intended for profit-making companies and are based on the needs of their users, in particular current and potential investors. Thanks to the Standards, investors can get high-quality information, especially about the financial situation of companies that will assist them in their investment decision-making (Dvořáková, 2017).

This brief introduction is followed by a review of literature that addresses an objective which is similar to this article, namely to determine whether publicly traded companies on the Prague Stock Exchange (PSE) comply with the disclosure requirements imposed on them by IFRS. Subsequently are briefly explained the basic issues of IAS 36 that are specifically addressed in this article. Four information requirements are in turn selected and subsequently tested within the published financial statements. In the conclusion are presented the results of the analysis and the reasoning why this information is not disclosed. Finally, the consequences of the absence of this information are drawn.

18.2 Literature Review

IAS 36 has been effective for many years, and much has been written about it. The same applies to the verification of the disclosure of mandatory information. However, reference to the direct impact of the violations of this obligation of disclosures is missing in the tests carried out under Czech conditions. In addition, the tests were performed on older data, so it is also intended to analyse whether the situation has improved.

Ašenbrenerová (2016) deals with IFRS 12 Disclosure of Interests in Other Entities and analyses the minimum required information that an investor should disclose about entities in which he has an interest. This article, unlike those that follow, had proven a relatively high percentage of compliance with disclosure obligations, 96–97%. Ašenbrenerová (2016) analyses mainly basic information presented on face of the balance sheet and profit and loss statements, distinguishing the financial and non-financial companies. The year examined is 2014.

Pospíšil (2017) focuses on the information required by IFRS 3 Business Combinations. According to the results of the tests performed using the D-score model, compliance with disclosure ranged between 47 and 86%, which represents a relatively large variance. Unlike other articles, the rate of disclosure has slightly improved during the reporting period, 2011–2014.

Another author, Dvořák (2017), focuses on IFRS 13 Fair Value Measurement. The author tests whether Czech companies publish the information required by the Standard. The research initially shows good results, when only a quarter of the companies correctly distinguish fair value with respect to the fair value hierarchy. Eventually, the results of the investigation deteriorated and resulted in the concluding finding that almost 50% of the companies in the test sample did not report changes between the hierarchy levels and more than 60% of the companies did not describe the valuation techniques used in the fair value measurement.

The last covered author is Červený (2017), who focused on IFRS 2 Share-Based Payment in 2013–2015. Like the previous authors, he monitors the quality of published information. In this case, he compares them to randomly selected companies from the German Deutscher Aktien Index (DAX). According to empirical evidence, some Czech companies fail to comply with the disclosures required by IFRS 2. On the other hand, according to the article, companies from the German market publish an exhaustive volume of information beyond the minimum obligations.

All these articles were based mainly on data from Czech companies, which are from the Prague Stock Exchange. With the exception of Ašenbrenerová (2016) and Červený (2017), these articles prove the unequivocal failure to comply with the disclosure requirements of IFRS.

18.3 Theoretical Basis

The cornerstone of IAS 36 is the cautionary principle of not overestimating assets and not underestimating liabilities. The condition is also a presumption of continuity, i.e. the continuation of the company in the future, which will allow the use of long-term asset benefits (Dvořáková, 2017).

The impairment of assets applies to most fixed assets. Their definition is so extensive that the Standard rather states to which assets it does not relate:

– Inventories (see IAS 2)
– Contract assets and assets arising from costs to obtain or fulfil a contract that are recognised in accordance with IFRS 15
– Deferred tax assets (see IAS 12)
– Assets arising from employee benefits (see IAS 19)
– Financial assets within the scope of IFRS 9
– Investment property measured at fair value (see IAS 40)
– Biological assets related to agricultural activity within the scope of IAS 41
– Deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of IFRS 4
– Non-current assets (or disposal groups) classified as held for sale in accordance with IFRS 5 (IASB, 2013)

So IAS 36 mainly deals with the following:

– Property, plant and equipment
– Intangible assets
– Goodwill
– Investments valued by equivalence
– Investments in subsidiaries and
– Investments in property in initial costs (IASB, 2013)

The objective of this Standard is to determine the procedures to be applied by an entity to ensure that its assets are carried at up to the maximum of the recoverable amount, that is to say, do not exceed the recoverable amount (IASB, 2013),

The recoverable amount is determined as the higher of the value in use or fair value less the costs of disposal. The value in use reflects the present value of future net cash flows that will be generated by the use of the asset, including the potential revenue from its sale. If the recoverable amount is less than the carrying amount, an impairment loss for the asset is recognised and it is included in the profit and loss statement. The value of the asset being analysed is reduced (Dvořáková, 2017).

If the recoverable amount of an individual asset cannot be determined, it is determined for the so-called cash-generating unit. This represents the smallest possible group of assets that separately generates divisible cash flows (Dvořáková, 2017).

Asset impairment testing shall be performed at least once a year for intangible assets with indefinite useful lives, intangible assets at the acquisition stage and goodwill from a business combination. Other assets are tested at the instigation of external or internal indicators. The main external indicators are as follows:

– Reduction in the price of an asset is faster than expected when determining its depreciation.
– Change in the market interest rate.
– The carrying amount of the entity's net assets is greater than its market capitalisation.
– Changes in the market, economic, legislative or technological environment (IASB, 2013).

Internal indicators may be as follows:

– Evidence of obsolescence or physical damage to the asset.
– Negative changes affecting the entity to the extent to which or the manner in which the asset is used.
– Internal statements contain signals that indicate that the asset's economic performance is, or will be, worse (IASB, 2013).

If the effect of these indicators ceases, the impairment loss of the asset may be reversed and the value of the asset may increase. The exception is goodwill, for which this loss must not be reversed.

The disclosure requirements of this standard are quite extensive, so only those that will be examined are noted below:

1. Amount of an impairment loss.
2. If the recoverable amount of the cash-generating unit is based on the value in use, disclosed are the discount rate used to estimate the value in use and the rate of growth used to extrapolate cash-flow plans.
3. Events and circumstances that led to the recognition of an impairment loss.
4. If the recoverable amount is based on the value in use, an entity shall disclose the description of each key assumption on which the cash flow plans are based.

18.4 Testing of Mandatory Disclosed Information

The Prague Stock Exchange, more precisely the companies from the stock and bond market, was chosen for the survey on disclosed information. Initially, the sample contained 62 companies, but it was clear that it was necessary to sort some companies out because they did not correspond to the subject of the analysis. The first condition was that the companies were listed on the public market for the entire period of 2015–2017 and they were not just short-term “participants”. Furthermore, there had to be traceable annual reports prepared under IFRS. At least one of the annual reports of each company had to allow for electronic extraction of data; that is, the report could not be, e.g., only optically scanned. This requirement allowed the annual reports to be text-based searched since the information for this survey has been scattered across entire documents. Duplicities have been eliminated. The final condition was compliance with the assumption of going-concern (see the previous chapter).

A relatively large number of companies that did not meet the selection conditions were excluded from the survey (see the left-hand part of Table 18.1). The right-hand part of the table shows the distribution of the final sample of companies, which is unfortunately not even on the part of the stock market. The sample ended up with 32 companies.

Due to their unevenness, the observed values will be presented in tables as percentages. In the left-hand side table, there will always be a share of the companies with at least one positive finding in the total number of companies. The right-hand side table will show the ratio of the number of positive findings to the total possible number of findings (this is three times the number of companies given the three-year reporting period).

18.4.1 Mandatory Disclosed Information for Positive Impairment Testing of Goodwill

As already mentioned towards the end of the third chapter, in positive goodwill impairment testing, the annual report should include, inter alia, the amount by which the value is impaired. In cases when the value in use is adopted, the discount rate and the rate of growth used to extrapolate cash flow plans should also be provided.

Table 18.1 Selection of companies

	Companies on the stock market	Companies on the bond market		Companies on the stock market	Companies on the bond market
Original number of companies	27	35	Financial companies	4	7
Number of selected companies	17	15	Non- financial companies	13	8

Source: PSE (2019) and authorial computation

Table 18.2 Observed impairment of goodwill

	Companies on the stock market (%)	Companies on the bond market (%)		Companies on the stock market (%)	Companies on the bond market (%)
Financial companies	75.0	14.3	Financial companies	41.7	9.5
Non-financial companies	23.1	12.5	Non-financial companies	7.7	8.3

Source: Annual reports and authorial computation
Note: Left-hand: share of the companies with a positive finding. Right-hand: share of positive findings for the entire reporting period

Out of the 32 examined companies, eight did not show goodwill in their balance sheets at all during the observed period. Of the remaining companies, there were only eight that reported a total of 12 goodwill impairments during the observed period (see Table 18.2). Six companies used the value in use for testing, only one adopted fair value less the costs of disposal and one used both of these methods.

The amount was reported for all impairments. There were no significant differences in the distribution of impairments between individual years and the financial and non-financial companies. Significant is the absence of the discount rate in two cases, representing about 17% of the positive occurrences. The growth rate for subsequent extrapolation (about 33%) was also missing for these two companies and two other firms. In addition to the numerical values for these impairments, accepted were also statements that no growth rate for the second phase was considered.

The focus on this information was mainly due to the investors' own efforts to determine the discount rate. The reported discount rate may serve as a guide for determining the investors' own discount rate for their valuation of the company and their subsequent decision on a possible investment. However, it should be borne in mind that the discount rate under IAS 36 is reported as a pre-tax quantity.

18.4.2 Mandatory Disclosed Information for Positive Impairment Testing of Property, Plant and Equipment

The selection of this group was also influenced by the importance of the information that the annual report could provide in the case of positive testing. For some companies, property, plant and equipment play a crucial role, and reasons for their impairment may have a decisive impact on the valuation of the company itself.

There were many more positive tests in this category, with a total of 14 impaired companies reporting 32 impairments, one third of the possible observations (see Table 18.3 for more details). As in the previous chapter, there were no trends in individual markets, year-on-year development or the types of companies.

Table 18.3 Observed impairment of property, plant and equipment

	Companies on the stock market (%)	Companies on the bond market (%)		Companies on the stock market (%)	Companies on the bond market (%)
Financial companies	75.0	28.6	Financial companies	75.0	28.6
Non-financial companies	46.2	37.5	Non-financial companies	30.8	20.8

Source: Annual reports and authorial computation
Note: Left-hand: share of the companies with a positive finding. Right-hand: share of positive findings for the entire reporting period

Admittedly, the problem is that in 23 cases, i.e. in about 72% of the positive findings, the reasons for the impairment were missing, which is a diametrical difference from the previous chapter. Just to clarify, in some cases, it has been explained that the recoverable amount is higher than the book value, but this is not considered an acceptable explanation. The most common reason for the impairment was the fall in the prices of manufactured products, as well as increased regulation, reference to the result of the expert opinion, lower economic performance than expected and doubts about the future use of assets. Interestingly, Unipetrol, which did not detect any indicators of possible impairment, carried out tests with a subsequent impairment.

18.4.3 Mandatory Disclosed Information for Positive Impairment Testing of Investments in Subsidiaries

The next information under test was the reason that led to impairments in the value of investments in subsidiaries. This information is important because subsidiaries in many cases represent foreign branches or a related, though not the same, production or service. Some publicly traded companies have dozens of subsidiaries, while five companies from the sample did not have any; four of these fall under the non-financial type from the bond market.

In this category, there were ten companies with a positive test for impairment of investments in subsidiaries (see Table 18.4). Again, no clear trend or deviation was observed. In total, 16 impairments were reported, but only three of them were reported together with a reason; that is, approximately 81% of cases were without a reason. There were only two kinds of reasons: decrease in profitability and negative development of the geopolitical and economic situation.

Table 18.4 Observed impairment of investments in subsidiaries

	Companies on the stock market (%)	Companies on the bond market (%)		Companies on the stock market (%)	Companies on the bond market (%)
Financial companies	0.0	42.9	Financial companies	0.0	23.8
Non-financial companies	38.5	25.0	Non-financial companies	23.1	8.3

Source: Annual reports and authorial computation
Note: Left-hand: share of the companies with a positive finding. Right-hand: share of positive findings for the entire reporting period

18.4.4 Key Assumptions upon Which Cash Flow Plans Are Based

The key assumptions upon which the cash flow plans are based when using the value in use to determine recoverable amounts are also required to be disclosed. These assumptions may complement the risks that a potential investor can include in his/her valuation of or comparison with other companies and in determining whether they are subjected to the same risks. Although from the previous three tests there were 21 companies that showed positive results from impairment tests (see Sects. 18.4.1, 18.4.2, and 18.4.3), only two of them had disclosed these assumptions. In addition to these subjects, there was one more company that has reported assumptions. For several companies, the key stated assumption was that the rate of return should not fall below the discount rate, which is nevertheless obvious and not meaningful, so it was not considered a sufficient argument. Among the accepted reasons were the assumptions of a stable excise tax and stable costs of raw materials, followed by stable inflation and others.

18.5 Conclusion

This paper examined compliance with information obligations under IAS 36 Impairment of Assets in the annual reports of companies traded on the Prague Stock Exchange in the Czech Republic. The analyses carried out confirmed long-term non-compliance with these obligations.

Within the scope of the undertaken analysis, as an author, I can say that, generally, better prepared and more comprehensible were the annual reports of companies from the stock market. Among the best, I would rate the annual reports of ČEZ, a.s.; this company has reported all the categories of impairment losses and also included almost all the mandatory data. On the other hand, financial companies from the bond market fared rather badly, mainly because of the impossibility to distinguish among impairments. The reason was their inclusion in the accumulated depreciation of property, plant and equipment or their inclusion in financial assets, which are dealt with in IFRS 9.

Annual reports should be a comprehensive source of neutral information. Although it is understandable why companies try to provide information in a better light than they actually are, it is not admissible not to give information at all or not to justify them more precisely. The fact is – as demonstrated by the literature review – that the situation has been unsatisfactory for a long time, and no positive shift can be seen.

If the Prague Stock Exchange is to catch up with the developed markets in the future, the situation has to improve in many ways. Low liquidity leads to expensive trading and large real spreads. It does not make sense to trade on PSE for small investors. In addition, if these small investors do not closely monitor the development of companies and some information behind the numbers is missing, they must look for additional resources. This increases the time required and makes investment decisions more difficult. The result is a further reduction in market liquidity. Therefore, the currently traded companies can contribute to market quality improvement "simply" by improving their annual reports.

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