

Case 09-7
A2 Auto Corporation Impairment

A2 Auto Corporation (“A2 Auto”) is one of the world’s largest manufacturers and distributors of automobiles and automobile ancillary parts operating in the Asia Pacific and American Markets. A2 Auto’s automotive operations include the design, manufacture, assembly, and sale of passenger cars, recreational and sport-utility vehicles, minivans and trucks, and related parts and accessories.

In its Form 10-K, filed with the U.S. Securities and Exchange Commission (“SEC”), A2 Auto has disclosed within Note 24, *Segment Information*, that it has four operating segments: (1) A2 Americas, (2) A2 Asia Pacific, (3) A2 Others, and (4) Financial Services. Note 12, *Goodwill and Other Intangibles*, discloses that A2 Auto has the same four reporting units.

The following is disclosed within Note 11, *Impairment of Long-Lived Assets*, of A2 Auto’s 2006 Form 10-K:

1. On the basis of the assumptions underlying the acceleration of our strategy refocus, we project a decline in net cash flows for the A2 Auto Americas segment, primarily reflecting lower market share assumptions, capacity reductions, and other aspects of our accelerated plan. As a result, in the third quarter of 2006, we tested the long-lived assets of this segment for recoverability and recorded a pretax impairment charge of \$1.76 billion in automotive cost of sales, representing the amount by which the carrying value of these assets exceeded their fair value.
2. During the third quarter of 2006, we also reviewed our business plan for the Alpha and Beta operating units within our Asia Pacific segment and, consistent with 2006 operating results, projected lower sales, a decline in net cash flows for these operating units based on cost performance shortfalls, and currency exchange deterioration. As a result, we tested the long-lived assets of these operating units for recoverability and recorded a pretax impairment charge of \$1.28 billion in automotive cost of sales, representing the amount by which the carrying value of these assets exceeded their fair value.
3. During 2005, we updated our Asia Pacific Improvement Plan for the Alpha and Beta operating units. We projected a decline in net cash flows for the Alpha and Beta operating units based on updated market projections primarily reflecting recent market performance for Alpha. As a result, we tested the long-lived assets of these operating units for recoverability and recorded a pretax impairment charge of \$1.04 billion in automotive cost of sales, representing the amount by which the carrying value of these assets exceeded their fair value.

In response to the filing of its 2006 Form 10-K with the SEC, A2 Auto received the following included in a comment letter from the SEC:

We note that you have determined that the appropriate level for long-lived asset impairment testing is at the A2 Auto Americas segment for your Americas operations and the Alpha and Beta operating units for the A2 Asia Pacific segment. Please explain this inconsistency and advise us as to the nature and structure of your operations in the Americas and Asia Pacific.

Refer to the “Appendix” for excerpts from its 2006 10-K and additional information.

Required:

Issue 1: What are the appropriate criteria for the grouping of long-lived assets to be held and used for impairment testing purposes?

Issue 2: On the basis of the information in A2 Auto’s 2006 Form 10-K, what is the appropriate grouping for purposes of recognizing and measuring an impairment loss?

Issue 3: What audit considerations should be made when testing the appropriate grouping of long-lived assets for purposes of recognition and measurement of an impairment loss?

Issue 4: Note 12 of the A2 Auto 2006 Form 10-K states:

[Goodwill impairment] testing is also performed following a triggering event for the long-lived asset impairment test. As a result of the impairment of the A2 Auto Americas segment and Alpha and Beta operating units in the third quarter of 2006, we tested goodwill at our A2 Auto Americas and Asia Pacific reporting units. No goodwill impairment was necessary.

Is A2 Auto’s approach for testing goodwill for impairment after recognizing an impairment charge related to a long-lived asset group classified as held-and-used appropriate? Why?

Issue 5: After the Americas \$1.76 billion impairment loss was recognized, a strategy refocus effort began which has resulted in an improved forecast for the Americas segment going forward. Should A2 Auto consider restoring the previous carrying amounts of these long-lived assets? Why?

Appendix
Excerpts from A2 Auto Corporation's 2006 10-K

Item 1. Business

General:

A2 Auto Corporation (herein referred to as "A2 Auto", "A2", the "Company", "we", "us" or "our") is a company registered under the laws of state of Delaware and was incorporated in 1945 as a manufacturer of automobiles catering predominantly to the North American market. Over the past few decades we have evolved as one of the world's largest manufacturers and distributors of automobiles and automobile ancillary parts with dominance in the Asia Pacific and Americas Markets. We are also engaged in the business of financing of vehicles. A2 Auto's automotive operations include the design, manufacture, assembly, and sale of passenger cars, recreational and sport-utility vehicles, minivans and trucks, and related parts and accessories. A2 Auto's financial services business ("A2 Finance") consists primarily of providing financing to dealers and their customers for the purchase or lease of A2 Auto vehicles.

In addition to the information about the Company contained in this Annual Report on Form 10-K for the year ended 2006, extensive information can be found on our website located at www.A2Auto.com. All of our recent periodic report filings with the Securities and Exchange Commission ("SEC") pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are made available free of charge through our website. The content of our website is not deemed to be incorporated by reference into this report nor should it be deemed to have been filed with the SEC. The SEC maintains its website (<http://www.sec.gov>) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with it.

A2 Auto primarily meets the demand of its customers with vehicles developed, produced, or marketed under the following brands:

- i. Cars: Alpha and Beta*
- ii. Sport-utility vehicles ("SUVs"): Delta*
- iii. Trucks: Gamma and Lambda.*

Overview:

Segments: We review and present our business under two sectors - Automotive and Financial Services. Within these sectors, our business is divided into reportable segments based upon the organizational structure that we use to evaluate performance and make decisions on resource allocation, as well as availability and materiality of separate financial results consistent with that structure.

Business Sector	Reportable Segment	Description
Automotive	A2 Americas	Includes the sale of A2 Auto vehicles and related service parts in the Americas markets and associated costs to design, develop, manufacture and service these vehicles and parts.
Automotive	A2 Asia Pacific	Includes the sale of A2 Auto vehicles and related service parts in Asia Pacific markets and associated costs to design, develop, manufacture and service these vehicles and parts.
Automotive	A2 Other Markets	Includes the sale of A2 Auto vehicles and related service parts in Europe and African markets and associated costs to design, develop, manufacture and service these vehicles and parts.
Financial	Financial Services	Includes financing, leasing and insurance related to vehicles.

Automotive - General:

A2 Auto estimates the global automobile sales for the year 2007 will be 75 million units. Substantially all of our automobiles are marketed through our retail dealers in the Americas and the Asia Pacific region and through dealers and distributors in others parts of the world. In addition to the products we sell to our dealers for retail sale, we also sell cars and trucks to our dealers for sale to fleet customers, including daily rental car companies, commercial fleet customers, leasing companies and governments.

Total industry sales volumes and revenues for new motor vehicles of domestic and foreign makes of A2 Auto's during the years ended 2006 and 2005 were as follows:

Particulars	(in millions)			(Units '000)		
	2006	2005	Change in % over / (under)	2006	2005	Change in % over / (under) (1)
A2 Auto Americas	\$6,000	\$6,792	(11.65)%	2,746	2,996	(8.34)%
A2 Auto Asia pacific	4,816	4,800	0.33%	2,061	2,013	2.38%
A2 Auto Others	624	664	(6.02)%	471	404	16.58%
Total	\$11,440	\$12,256	(6.66)%	5,278	5,413	(2.49)%

(1) Change over / (under) indicates the change in current year compared to the previous financial year of the company

See Management Discussion and Analysis under "*Results of Operations*" for further discussion.

Financial Services

A2 Auto offers a variety of automotive financing and insurance products to and through automotive dealers throughout the world. The predominant share of our financing and insurance business consists of financing our vehicles and supporting our dealers. A2 Finance operates in all regions in which the automotive business has a presence. A2 Finance's primary financial products fall into the following categories:

Retail financing:

Offering financing to commercial customers, primarily vehicle leasing companies and fleet purchasers, to purchase or lease vehicle fleets;

Wholesale financing:

Making loans to dealers to finance the purchase of vehicle inventory, also known as floor plan financing;

Other financing:

Making loans to dealers for working capital, improvements to dealership facilities, and the acquisition and refinancing of dealership real estate.

Revenues:

Revenues in percentages of vehicle sales of A2 Auto were as follows:

Particulars	2006	2005	2004	2003	2002
CARS and SUVs					
Alpha	22.00%	19.00%	17.50%	15.50%	17.50%
Beta	18.00%	16.00%	19.00%	17.50%	17.50%
Delta	15.00%	19.50%	20.00%	25.50%	22.50%
Total A2 Auto car sales	55.00%	54.50%	56.50%	58.50%	57.50%
TRUCKS					
Gamma	23.00%	17.50%	23.00%	20.50%	20.00%
Lambda	22.00%	28.00%	20.50%	21.00%	22.50%
Total A2 Auto truck sales	45.00%	45.50%	43.50%	41.50%	42.50%
Total A2 Auto vehicle sales	100.00%	100.00%	100.00%	100.00%	100.00%

Item 7. Management's discussion and Analysis of financial condition and results of operation

CONSOLIDATED RESULTS OF OPERATIONS

Our global net loss from continuing operations was \$10,092 million or \$6.61 per share of Common Stock in 2006, down \$11,244 million from a profit of \$1,152 million or \$0.78 per share in 2005.

	<i>(in millions)</i>		
	2006	2005	2004
Revenue			
Automotive sector	\$114,645	\$122,779	\$117,695
Financial services sector	13,453	18,738	20,158
Total Revenue (a)	128,098	141,517	137,853
Expenses			
Automotive cost of sales (b)	119,095	115,939	108,604
Selling, administrative and other expenses	15,344	19,698	19,210
Interest expense (c)	7,026	6,734	6,777
Financial Services provision for credit and insurance losses	193	386	970
Total cost of expenses	141,658	142,757	135,561
Income/(loss) from continuing operations	(10,092)	1,315	2,547
Net income/(loss)	\$(10,090)	\$1,152	\$2,430

- a) Total Company revenues in 2006 decreased by \$13,418 million from 2005, of which decrease \$8,133 is automotive revenues and \$5,285 is financial services revenues. The decline in automotive revenues is primarily due to reduced margins on all automotive products, increased competition in the Americas markets and incremental new manufacturing capacity of Japanese and Korean manufacturers in the Americas and the Asia Pacific region. A2 finance revenues are directly impacted due to decreased automotive revenues.
- b) Automotive cost of sales as a percentage of total expenses increased by 2.86% which was primarily due to increased raw material prices.
- c) The increase in interest expense is primarily due to higher borrowing costs.

Included in Income/(loss) before income taxes are items we do not consider indicative of our ongoing operating activities (“Special items”). The following table details 2006, 2005, and 2004 special items by segment or business unit:

	<i>(in millions)</i>		
	2006	2005	2004
Pension curtailment charges	\$(2,193)	\$—	\$—
Fixed asset impairment charges	(1,760)	—	—
Fuel-cell technology charges	—	(93)	(146)
Divestiture of non-core business (ABC Group, LLC)	—	(47)	—
Legal settlement relating to social welfare tax liability	88	—	—
Personnel-reduction programs	(67)	(408)	(39)
Total	\$(3,932)	\$(548)	\$(185)

Automotive Sector Results of Operations

Details by Automotive segment of *Income/(loss) before income taxes* are shown below:

	<i>(in millions)</i>				
	2006	2005	2004	2006 over 2005	2005 over 2004
Americas	\$(12,246)	\$(1,636)	\$535	\$(10,610)	\$(2,171)
Asia Pacific	(1,249)	(1,325)	(418)	76	(907)
Others	156	117	(135)	39	252
Total	\$(13,339)	\$(2,844)	\$(18)	\$(10,495)	\$(2,826)

Details of sales and wholesale unit volumes by Automotive segment are shown below:

	Change 2006 over 2005				Change 2005 over 2004			
	Revenues (in billion)	%	Units in '000 No.s	%	Revenues (in billion)	%	Units in '000 No.s	%
Americas	\$(7.92)	(11.65)%	250.4	(8.36)%	\$(0.8)	(1.16)%	127.2	(4.07)%
Asia Pacific	0.16	0.33%	47.2	2.34%	4.88	11.28%	6.4	0.32%
Others	(0.4)	(6.02)%	67.2	16.63%	1.04	18.57%	60.8	17.72%
Total	\$(8.16)	(6.66)%	-136	(2.51)%	\$5.12	4.35%	(60)	(1.10)%

For discussion of our revenue recognition policy for these sales, see Note 1 to the Financial Statements.

Industry vehicle unit sales in the Americas declined due to a strategic decision to reduce sales to daily rental customers, because of the comparatively low profits from such sales, and due to a consumer shift to passenger cars where A2 Auto traditionally has lower penetration.

In Asia Pacific, vehicle unit sales increased primarily due to an increase in volumes of the sale of the new version of the low margin Alpha cars.

In the Other Markets the increase in vehicle unit sales was offset by the effects of pricing pressures and a change in product mix towards lower margin vehicles in 2006.

Income/(loss) was further decreased by the details as mentioned in the "Special items" tabulated above.

Financial Services Results of Operations

i. Change over 2005

	Revenue (in millions)			Income / (loss) (in millions)		
	2006	2005	Change over / (under) 2005	2006	2005	Change over / (under) 2005
A2 Financial services	\$13,453	\$18,738	\$(5,285)	\$1,573	\$3,962	\$(2,390)

A2 Finance's revenue declined by \$5,285 million. The decrease in A2 Finance's earnings primarily reflected higher borrowing costs and depreciation expense. The remaining decrease in earnings primarily reflected the impact of lower retail receivable levels, offset partially by improved credit loss performance.

i. Change over 2004

Particulars	Revenue (in million)			Income / (loss) (in million)		
	2005	2004	Change over / (under) 2004	2005	2004	Change over / (under) 2004
	A2 Financial services	\$18,738	\$20,158	\$(1,420)	\$3,962	\$3,430

A2 Finance's revenues decreased by \$1,420 million to \$18,738 million in 2005 and income before income taxes had increased by \$533 million. The decrease in revenues but increase in income was offset partially by improved credit loss performance.

Strategy and trends:

To address the market reality and the factors and trends affecting the automotive industry discussed above, we have been focusing on the following three key priorities:

- Restructuring the Company to be profitable at lower volumes and with a changed vehicle mix;
- Accelerating product development and reducing manufacturing complexity;
- Obtaining and maintaining adequate liquidity to fund the first two priorities.

Restructuring operations

Aggressive restructuring plans of the automotive business have been devised to address issues such as how to compete more effectively in today's global marketplace and particularly in the Americas. These plans focus on higher fuel prices and shifting model mix from trucks and large SUVs to more fuel-efficient vehicles. The restructuring initiative includes reductions of our global workforce to contribute to our goal of reducing annual Americas operating costs by \$4 billion by the end of 2009.

Accelerating product development and reducing manufacturing complexity:

As part of the acceleration of our strategy refresh, 70 percent of Alpha and Beta products (by volume) in the Americas will be new or significantly upgraded by the end of 2008 compared with 2006 models.

These efforts will include the expansion of our product lineup in growth products such as crossover vehicles and hybrid vehicles. We will leverage our scale by applying our global product development capital and engineering resources to fewer vehicle platforms. This commonality of platforms in turn, will reduce complexity in our vehicles and processes.

Inflation:

The effect of inflation is not considered material to the overall financial statements of the company.

Other Information

As the auditor of A2 Auto, you have also obtained the following additional information on the company's operations in the course of your audit procedures:

One of A2 Auto's manufacturing plants has identical assembly lines that produce various types of products. Line 1 manufactures the Beta-hybrid car, which is a high-volume, high-margin product. Line 2 manufactures the Delta SUV, which has high margins but low volume. Since the assembly lines are mechanically identical, Line 2 can produce the Beta-hybrid by making only minimal mechanical adjustments.