IMPAIRMENT - IAS 36

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Introduction

Intangible assets, particularly goodwill, have constituted a significant proportion of the purchase consideration in business combinations over recent years. The increased emphasis on the identification of intangible assets and the mandatory annual impairment testing of goodwill has highlighted the importance of impairment as a management issue. Indeed, the consequences of recognising impairment losses can lead to increased volatility in reported earnings. The primary objective of accounting for the impairment of assets (IAS 36) is to ensure that assets are not stated in the statement of financial position (SOFP) at more than they are worth to the business (recoverable amount). Where asset carrying amounts are not recoverable through the returns generated from them the underlying assets are impaired and should have their carrying amounts reduced accordingly. A key financial reporting issue is how to calculate an asset's recoverable amount and it should be recognised that such a calculation involves a judgemental process within a framework carried out by management within the organisation. Disclosures, however, allow key users to review the assumptions inherent in the impairment calculation. While in recent years, interest rates in most developed countries have been very low, a relatively small increase in rates could have a significant impact on present values of cash flows. An impairment review is intended to ensure that published accounts comply better with the objectives of financial reports as set out in the IASB's *Framework for the Preparation and Presentation of Financial Statements.* One consequence of the move towards the use of fair values, as opposed to historical cost, should be the publication of financial statements that are more comprehensible (and possibly relevant) to many users unfamiliar with the technicalities of accounting. However, it could equally be argued that the use of fair values may result in the publication of less reliable financial information. IAS 36 supports users by seeking to ensure that non-current and other asset carrying amounts will be, at a minimum, recovered from future operations. This avoids the overstatement of profits and capital employed which would occur if assets were carried at above their recoverable amounts. Properly recognised impairment losses are likely to reduce the return on capital employed and increase gearing to more realistic levels, and in doing so, provides more realistic and decision useful information to users of financial statements.

Scope

IAS 36, *Impairment* applies to all tangible, intangible and financial assets except inventories (IAS 2), assets arising from construction assets (IAS 11), deferred taxation assets (IAS 12), assets arising from employee benefits (IAS 19) and financial assets within the scope of IFRS 9 (IAS 39). This is because those IAS's already have rules for recognising and measuring impairment. Note also that IAS 36 does not apply to non-current assets held for sale which is covered by IFRS 5.

The main accounting issues that need to be considered are:

- What are the indicators that help to identify whether impairment may have occurred?
- How should the recoverable amount of an asset be determined?
- How should an impairment loss be reported within the financial statements?

Indications of impairment

Questions on Advanced Corporate Reporting are unlikely to specify that you should carry out an impairment review. It is more likely that candidates would be expected to identify indicators of impairment within the narrative of the case study. IAS 36 states that an entity should look for **evidence of impairment at each reporting date**. As a minimum the following indicators should be considered.

External sources	**Internal sources**
• Significant decline in the market value of the asset that is more than would be expected from passage of time or normal use, for example, increased competition.	• Evidence of obsolescence or physical damage
• Significant changes in the technological, market legal or economic environment in which the business operates. • An increase in market interest rates of return on investment likely to affect the discount rate used in the calculation of value in use.	• Significant changes which have an adverse effect on the entity: ▪ The asset becomes idle ▪ Plans to discontinue/restructure operations ▪ Plans to dispose of asset before previously expected date ▪ Reassessing an asset's useful life as finite rather than indefinite.
• The carrying amount of the entity's net assets being more than its market capitalisation.	• Internal evidence that asset performance is or will be less favourable than expected

If such indications are evident, the asset's recoverable amount should be estimated, in other words an impairment review should be carried out. It is important to note that when assessing internal factors an entity should compare the **cash flows** associated with an asset, or group of assets, with those **budgeted**. Irrespective of whether there are indicators of impairment, **annual impairment tests** are required for: intangible assets with an indefinite useful life; and goodwill acquired in a business combination.

Measuring the recoverable amount of an asset

Assets should be carried at no more than their recoverable amount. Impairment should be determined by comparing the carrying amount of the asset with the recoverable amount. Where there are indications of impairment an entity should assess the recoverable amount of the asset, or group of assets. Where the **carrying amount exceeds the recoverable amount** the asset is **impaired**.

The recoverable amount is **higher** of

Fair value less costs to sell

Value in use

An asset's fair value less costs to sell is the amount net of selling costs that could be obtained from the sale of an asset or cash generating unit in an arm's length transaction between knowledgeable willing parties. Selling costs include sales transaction costs, such as legal expenses and costs of removing the asset. If there is an **active market** in the asset, the net selling price should be based on the market value, or on the price of recent transactions in similar assets. If there is **no active market** in the assets it may be possible to estimate a net selling price using best information available of what 'knowledgeable, willing parties' might be willing to pay in an orderly transaction between market participants at the measurement date.

The value in use is an important concept. Instead of selling an asset, an entity can trade with the asset producing cash flows by producing and selling products or providing a service. The value in use is the present value of the future cash flows (inflows minus outflows) derived from an asset (or cash generating unit), including its estimated net disposal value (if any) at the end of its expected useful life. The following elements should be reflected in the calculation of an asset's value in use:

- An estimate of the future cash flows the entity expects to derive from the asset
- Expectations about possible variations in the amount or timing of those future cash flows
- The time value of money (represented by the current market risk-free rate of interest)
- The price for bearing the uncertainty inherent in the asset
- Other factors that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

In summary, estimating the value in use involves estimating the future cash flows attributable to the asset, and the application of an appropriate discount rate to those future cash flows. Companies need to plan ahead. Market capitalisation below net asset value is an impairment trigger, and calculations of recoverable amount are need. If the stock market value of the company is lower than the value in use calculation, then the assumptions used for this calculation may need investigation.

Estimating future cash flows

Cash outflows should not include outflows relating to obligations already recognised as liabilities and no account should be taken of future restructuring costs which the entity is not yet committed to. In order to guard against the use of over-optimistic estimates of cash flows IAS 36 states the following:

1. Cash flow projections should be based on reasonable and supportable assumptions made by management.
2. Cash flow projections should be based on the most recent financial budgets or forecasts. These budgets should cover a maximum period of five years unless a longer period can be justified.
3. For cash flow projections beyond five years, detailed cash flows budgets are unreliable and management should just extrapolate the fifth year using a steady or declining growth rate. IAS 36 does permit an increasing growth rate if, in the unlikely case, it can be justified.

Discounting

The cash flows should be discounted at an appropriate rate using a pre-tax rate (and pre-tax cash flows) that reflects current market assessments of the time value of money and the risks specific to the asset for which future cash flow estimates have not been adjusted. Discount rates must be sensible. Interest rates in most countries are falling, but other factors affect discount rates in impairment calculations, including corporate lending rates, weighted average cost of capital and risks associated with cash flows, all of which are increasing within the current global economic environment.

Example 1

X Ltd has a single manufacturing plant which has a carrying amount of £900,000. A new government has passed legislation which significantly restricts exports of the product produced by the plant. As a consequence, and for the foreseeable future, X Ltd's production will be cut by 40%. Cash flow forecasts have been prepared derived from the most recent budgets/forecasts for the next five years approved by management.

Year	1	2	3	4	5
	£000	£000	£000	£000	£000
Future cash flows	280	253	188	125	280 (including disposal proceeds)

If the plant was sold now if would realise £660,000, net of selling costs. X Ltd estimates the pre-tax discount rate specific to the plant to be 15%, excluding the effects of general inflation. Calculate the recoverable amount of the plant and any impairment loss.

The fair value less costs to sell of the plant is below its carrying value so it may be impaired. It is now necessary to estimate the value in use in order to determine whether impairment has occurred and to quantify the impairment loss.

Year	*Future cash flows*	*Discount rate 15%*	*PV*
	£000	£000	£000
1	280	0.86957	243
2	253	0.75614	191
3	188	0.65752	124
4	125	0.57175	71
5	280	0.49718	139
Value in use			768

	£000
Recoverable amount (higher of value in use and fair value less costs to sell)	768
Impairment loss (900 -768)	132

Recognising an impairment loss – individual asset

If the recoverable amount of an asset is lower than the carrying amount, the carrying amount should be reduced by the difference (i.e. the impairment loss) which should be charged as an expense to the statement of comprehensive income.

An impairment loss on an asset held at a revalued amount should be treated as a revaluation decrease under the relevant IAS. In practice this means:

- To the extent that there is a revaluation surplus held in respect of the asset, the impairment loss should be charged against the revaluation surplus
- Any excess should be recognised in the statement of comprehensive income.

Example 2

Oscar PLC acquired its head office on 1 January 2001 at a cost of £10 million (excluding land). The company's depreciation policy is to depreciate property over 50 years on a straight line basis. Estimated residual value is zero. On 31 December 2005, Oscar PLC revalued the non-land element of its head office to £16 million. In accordance with IAS 16 *Property plant and equipment* the company has elected not to transfer annual amounts out of revaluation reserves as assets are used. In January 2011 storm damage occurred and the recoverable amount of the head office property (excluding land) fell to £5.8 million.
According to IAS 36, what impairment charge should be recognised in the statement of comprehensive income arising from the impairment review in January 2011?

IAS 36 and IAS 16 require that an impairment that reverses a previous revaluation should be recognised through other comprehensive income to the extent of the amount in the revaluation surplus for the same asset. Any remaining amount should be recognised in the statement of comprehensive income. Thus:

Carrying value at 31 December 2005 is 45/50 X £10m	= £9m
The revaluation reserve (£16 - £9)	= £7m
The carrying amount at the 31 December 2010 is 40/45 x £16	=£14.2m
The recoverable amount at 31 December 2010	= £5.8m
The total impairment charge is (£14.2 -£5.8)	= £8.4m

Of this, £7m is a reversal of the revaluation reserve, so only £1.4m is recognised through the statement of comprehensive income.

Cash generating units (CGU)

Where it is not possible to estimate the recoverable amount of an individual asset, the entity should estimate the recoverable amount of the CGU to which it belongs and perform the impairment test on the CGU.

A cash generating unit is the smallest identifiable group of assets for which independent cash flows can be identified and measured.

Example 3

Dasmart is part of a large food retail store chain Hallmart. Dasmart makes all its purchases through Hallmart's procurement centre at head office. All pricing, advertising and human resources (except for hiring of Dasmart's cashiers and sales representatives) are determined by Hallmart. Hallmart also owns three other stores in the same city (different districts) as Dasmart and 20 stores in other cities. All stores are managed in the same way as Dasmart. Dasmart and three other stores were purchased four years ago and good will was recognised.

Is Dasmart a CGU?

All Hallmart's stores are in different neighbourhoods and probably have different customer bases. So, although Dasmart is managed at corporate level, Dasmart generates cash inflows that are largely independent from those of Hallmart's other stores. Therefore, it is likely that Dasmart is a CGU in its own right.

As we can see from the definition and the worked example above, the identification of a CGU is a judgemental exercise. Factors which need to be considered include:

- How management monitors the entity's operations and performance (e.g. product lines, regions etc)
- How management makes decisions about continuing or disposing of the entity's assets and operations.

The carrying amount of a CGU is made up of the carrying amounts of the individual assets that can be directly attributed to it. Certain assets, however, may contribute to the revenue generating activities of the entity as a whole and it may be difficult to allocate to an individual CGU. Examples include corporate assets and goodwill. Vodafone, a leading mobile telecommunications company encountered problems in the recent past in relation to volatility of earnings. In addition, its areas of operation have been the subject of growing regulation. An impairment review conducted in 2005–6 resulted in a substantial write-down of goodwill associated, principally, with European operations which amounted to £23.5bn. The loss of £21.8bn reported for 2005–6, compared with a profit of £6.5bn in 2004–5, was mainly attributable to the increase in the impairment loss, up from just £0.5bn in the previous year.

Goodwill and impairment of assets

Goodwill arising from a business combination does not generate cash flows independently of other assets; it must be allocated to each of the acquirer's CGU's (or groups of CGUs) that are expected to benefit from the synergies of the combination. Each unit to which the goodwill is allocated should:

(a) represent the lowest level within the entity at which goodwill is monitored for internal purposes
(b) Not be larger than a reporting segment determined in accordance with IFRS 8 *Operating Segments.*

Goodwill that cannot be allocated to a CGU on a non-arbitrary basis should be allocated to each group of CGUs to which it relates.

Testing CGUS with goodwill for impairment

Goodwill should be tested annually for impairment irrespective of whether indicators are identified. A CGU to which goodwill has been allocated should be tested for impairment annually by comparing the carrying amount of the unit, including any goodwill, with the unit's recoverable amount. Any impairment loss is allocated to reduce the carrying amount of the CGU in the following order:

- First, reduce goodwill allocated to the CGU; and
- Then, reduce the other assets of the CGU on a pro rata basis.

Example 4
A CGU holds the following assets:

	£000
Goodwill	40
Patent	80
Property, plant and equipment	120
Total	240

An annual impairment review is required as the CGU contains goodwill. The most recent review assesses its recoverable amount to be £180,000. An impairment loss of £60,000 has been incurred and is recognised in the statement of comprehensive income. First, the entity reduces the carrying amount of goodwill. As the impairment loss exceeds the value of goodwill within the CGU, all the goodwill is written off. The entity then reduces the amount of other assets on a pro rata basis. Hence the remaining loss of £20,000 should be allocated pro rata between the property, plant and equipment and the patent. Revised balances should be as follows:

	£000
Goodwill (40 -40)	-
Patent 80 - (80/200 x 20)	72
Property, plant and equipment 120 – (120/200 x 20)	108
Total	180

Goodwill and non-controlling interests

The recoverable amount of a CGU relates to all the assets attributable to that CGU, including goodwill. If there is a non-controlling interest (NCI) in the CGU and at the acquisition date the NCI was measured at its proportionate share of the acquiree's net assets (also called partial goodwill method under IFRS 3, *Business Combinations*), then only the goodwill attributable to the owners of the parent will be recognised. However, part of the calculation of the recoverable amount of the CGU relates to the NCI's unrecognised goodwill. For the purposes of calculating the impairment loss, the carrying amount of the CGU should be notionally grossed up to include the goodwill attributable to the NCI. Any impairment loss calculated is only recognised in the statement of comprehensive income to the extent of the parent's share (the impairment loss allocated against the NCI's goodwill is a notional amount and is not recognised in calculating profit).

Example 5
On 1 January 2006 a parent acquired an 80% interest in a subsidiary for £1,600,000 when the identifiable net assets of the subsidiary were £1,500,000. The non-controlling interest was measured at the acquisition date at its share of the net assets. The subsidiary is a CGU. At 31 December 2010, the recoverable amount of the subsidiary was £1,100,000. The carrying amount of the subsidiary's identifiable net assets was £1,350,000.
Calculate the impairment loss to be recognised in the year ended 31 December 2010.
At 1 January 2006 the goodwill is calculated as follows:

	£000
Consideration	1,600
Non-controlling interest at share of identifiable net assets (20% x 1,500)	300
	1,900
Identifiable net assets	1,500
Goodwill	400

The carrying value of the net assets and goodwill amounts to £1,750,000. Because goodwill was calculated using the partial method at the acquisition date, goodwill needs to be grossed up to reflect the 20% NCI.

	Goodwill	Net assets	Total
	£000	£000	£000
Carrying amount	400	1,350	1,750
Unrecognised NCI (400 x 20/80)	100		100
	500		1,850
Recoverable amount			(1,100)
Impairment loss			750

The impairment loss should be allocated as follows.

	Goodwill (80%)	Goodwill (NCI)	Identifiable net assets
	£000	£000	£000
Carrying amount	400	100	1,350
Impairment	(400)	(100)	(250)
	-	-	1,100
Recoverable amount			1,100

The entity recognises an impairment of £650,000 (£400,000 + £250,000) in its financial statements, all of which is allocated to owners of the parent.

Reversal of an impairment loss

In some cases, the recoverable amount of an asset that has previously been impaired might turn out to be higher than the asset's current carrying value. In other words, there might have been a reversal of some of the previous impairment loss. In such cases:

- The reversal of the impairment loss should be recognised immediately as income in the statement of comprehensive income for the year
- The carrying amount of the asset should be increased to its new recoverable amount.

The reversal of an impairment loss for an asset should only be recognised to the extent that the carrying amount of the asset is revised to the amount it would have been (after subsequent depreciation) if no impairment loss has ever been recognised. An impairment loss recognised for goodwill should not be reversed in a subsequent period.

Disclosure

IAS 36 calls for substantial disclosure about impairment of assets. The information to be disclosed includes the following:

(a) For each class of assets, the amount of the impairment losses recognised and the amount of any impairment losses recovered (i.e. reversals of impairment losses)

(b) For each individual asset or CGU that has suffered a significant impairment loss, details of the nature of the asset, the amount of the loss, the events that led to the recognition of the loss, whether the recoverable amount is fair value price less costs to sell or value in sue, and if the recoverable amount is value in use, the basis on which this value was estimated (e.g. discount rates used etc).