

IFRS News

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IAS 36, Impairment of Assets – supplement • June 2007

IAS 36 Impairment – Frequently asked questions

This supplement is the third in the series highlighting frequently asked questions (FAQs) relating to the impairment process. IAS 36 defines recoverable amount as the higher of an asset's value in use (VIU) and fair value less costs to sell (FVLCTS). Value in use and fair value less costs to sell can be difficult to determine in practice. This edition addresses how impairment is measured, including common assumptions that are used to calculate each measure. It also looks at the determination of carrying amount and recognition of impairment losses.

Measuring recoverable amount

An asset is impaired when its carrying amount will not be recovered from its continuing use or from its sale. The recoverable amount of an asset is compared to the carrying amount to determine if an asset is impaired. An asset's recoverable amount is the higher of its VIU and its FVLCTS.

Question 1

Is it necessary to calculate both VIU and FVLCTS when performing an impairment review?

Answer 1

It is not always necessary to calculate both measures in an impairment review. For example, there is no need to calculate VIU if FVLCTS can be reliably estimated and is higher than the carrying amounts being reviewed.

Value in use

An asset's or CGU's VIU is the present value of the future cash flows expected to be derived from the use of the asset or CGU and from its disposal. The VIU calculation is not a fair value calculation or a proxy for fair value. VIU is a prescribed form of cash flow model set down in IAS 36 so that impairment testing is comparable.

Question 2

What happens when the VIU was determined based on the most recent financial budgets/forecasts that had not been formally approved by management?

Answer 2

A non-approved business plan does not represent a reliable source of information, as it may be subject to change. Cash flow projections are based on the most recent financial budgets/forecasts approved by management to determine the VIU.

Question 3

Should the most recently approved forecast be used without adjustment when determining VIU?

Answer 3

Adjustments to the forecasts may be necessary when determining the VIU. Forecasts must be based on reasonable and supportable assumptions that represent management's best estimate of the economic conditions over the asset's remaining useful life. Greater weight is given to external evidence.

Example

Management has recently approved a stretch forecast that shows production rising from 14,000 units to 20,000 units over five years. Recent years have demonstrated a track record of undershooting stretch forecasts. Analysts covering the sector are assuming that production will only rise marginally over the next few years due to forecast weaknesses in demand, together with oversupply in the market. Should the most recently approved forecast be used without adjustment?

Solution

The approved forecast appears to be neither reasonable nor supportable. The forecasts will need to be adjusted based on the entity's historic record of meeting projections and external evidence.

Question 4

The most recently approved forecasts assume that there will be a restructuring programme in the next financial year; however, no announcement has been made about the restructuring, and management has not started to implement such a plan. What adjustments, if any, does management need to make for the purpose of a VIU calculation?

Answer 4

When preparing a VIU calculation, the costs and benefits of the restructuring programme are stripped out of the forecasts. The benefits (and costs) of a restructuring programme can only be taken into account when a provision for the programme is made in the financial statements. This is only permissible when the entity is demonstrably committed to the restructuring – ie, through implementation of the restructuring or a formal announcement to those affected to raise a valid expectation of such plan.

Question 5

How does management assess when cash flow forecasts should terminate in order to assess VIU?

Answer 5

The general approach for a CGU that is a business with no predetermined or determinable lifespan is for the cash flow forecasts to include a terminal value. This, in effect, includes cash flows for an indefinite period. If the CGU has a finite life, the cash flow forecasts must not exceed this finite life.

Example

An entity has a number of items of plant and machinery with different useful lives within a production line that is a CGU. Management expects to replace the various assets at the end of their useful lives and continue to produce goods. How are the varying useful lives reflected in a VIU cash flow?

Solution

The cash flows cover the period in which the CGU is expected to generate benefits. The replacement of assets needed to maintain the current operating capacity of the CGU is assumed in the cash flow forecasts. The replacement expenditures for assets with shorter lives are therefore included in the future cash flows.

Question 6

How is the appropriate pre-tax discount rate for a VIU calculation determined from a post-tax starting point?

Answer 6

The following two-step approach can be applied to derive iteratively the implicit pre-tax discount rate from post-tax data. This pre-tax rate is applied to the discounted cash flows that are the basis of the VIU:

Step 1

From pre-tax cash flow projections, the expected actual tax cash payments are calculated to arrive at post-tax cash flows. These post-tax cash flows are discounted at an appropriate post-tax discount rate derived using information observable on the capital markets.

Step 2

The pre-tax discount rate is derived by determining the rate required to be applied to the pre-tax cash flows to arrive at the result obtained in step 1 (ie, same methodology used for computing an internal rate of return).

Fair value less costs to sell

When there is neither a binding sale agreement nor an active market, FVLCTS may be estimated as the amount that the entity could obtain from disposal of the asset in an arm's length transaction based on data from recent market transactions. Discounted cash flow techniques may be used in estimating the fair value of the asset.

Question 7

Can FVLCTS be determined reliably in the absence of a binding sale agreement or active market for an asset?

Answer 7

It is not necessary to have actual market transactions to support a FVLCTS calculation, as long as the projected cash flows and discount rate are consistent with the assumptions that market participants would make. If comparable transactions in similar assets or businesses are available, they are used as market evidence. If such benchmark or comparable market transactions do not exist, any possible external evidence (growth rates, discount rates, etc.) is used to support the cash flow projections. Based on this, it is almost always possible to determine FVLCTS.

Question 8

How is FVLCTS most reliably determined when it is based on a discounted cash flow technique?

Answer 8

Discounted cash flow techniques may be used incorporating assumptions that market participants would use in estimating the fair value of the asset. The key assumptions underpinning the cash flow analysis are benchmarked against market evidence. Any differences in the assumptions in the cash flows used for the FVLCTS compared to those used in the VIU analysis are also considered for reasonableness; for example, restructuring or improvement-type capital expenditure that IAS 36 does not allow in the VIU calculation may be taken into account in the discounted cash flows to determine the FVLCTS.

Determination of carrying amounts

The comparison of the recoverable amount of an asset (ie, FVLCTS or VIU) with its carrying amount to determine whether there is an impairment charge should be made on a consistent basis. FVLCTS and VIU use different assumptions and data. The carrying amounts are likely to differ for the comparison purposes with the recoverable amount (ie, FVLCTS or VIU).

Question 9

IAS 36 requires the recoverable amount, determined under FVLCTS or VIU (or both) to be compared to the carrying amount of the asset or CGU to determine if there is an impairment.

What is the 'carrying amount'?

Answer 9

Carrying amount is the accounting book value of an asset or the book value of the relevant assets and liabilities of a CGU. Many CGUs are businesses and will include both fixed assets and intangible assets, as well as working capital assets and liabilities and any other assets or liabilities. Only assets within the scope of IAS 36 are included in the carrying amount. For example, equity securities accounted for as 'available for sale' would not be included in the carrying amount of a CGU because those investments have their separate cash flows. Carrying amount must include any allocations of corporate assets or goodwill.

Question 10

Are the carrying amounts under FVLCTS and VIU always the same?

Answer 10

No. The components of VIU and FVLCTS are different. When comparing the recoverable amount (ie, FVLCTS or VIU) with the carrying amount to determine whether there is an impairment charge, that comparison should be made on a consistent basis. The elements in both sides of the comparison should be determined on a like-for-like basis.

Question 11

What categories of assets are included in the carrying amounts that are compared with the recoverable amount (ie, FVLCTS or VIU)?

Answer 11

Only operating assets are included in the carrying amounts because the recoverable amount (ie, FVLCTS or VIU) only includes operating cash flows for both calculations. Carrying amounts exclude financial assets, 'investment properties' and any other non-operating asset.

Question 12

Does the carrying amount of the CGU include any liabilities?

Answer 12

No. Liabilities are usually excluded from the carrying amounts (IAS 36.76(b)). Sometimes the recoverable amount of the CGU cannot be determined without consideration of a particular liability – for example, a decommissioning liability for a power station is included in the carrying amount.

Question 13

Should deferred tax liabilities be included in the carrying amount when the recoverable amount is based on VIU?

Answer 13

No. VIU is a pre-tax calculation, so deferred tax liabilities should be excluded from the carrying amount. On the contrary, FVLCTS is a post-tax calculation, so tax is considered and the carrying amount that is compared with FVLCTS includes the deferred tax liabilities.

Recognition of impairment losses

An impairment loss arising on a CGU is allocated first to goodwill allocated to the CGU, and second to the other non-monetary assets in proportion to their carrying amounts.

Question 14

An impairment charge has been recognised on a CGU to which goodwill has been allocated. Which assets in the CGU are written down first?

Answer 14

The goodwill is written off before other intangible and tangible fixed assets are impaired. However, no asset is written down below the higher of value in use, fair value less costs to sell or nil.

Question 15

Is it possible to have an impairment charge on a fixed asset in a CGU but not impair the goodwill attributed to the group of CGUs, which includes the CGU with the impaired fixed asset?

Answer 15

Yes. This results from step 1 of the following two-step approach:

Step 1

Individual assets and smaller CGU's that are included in a bigger CGU are tested individually excluding goodwill when there are indicators of impairment. This step allows the write-down of those assets that were impaired before the goodwill impairment. Management records any impairment on the CGU assets before the group of CGUs plus attributed goodwill are tested for impairment.

Step 2

The bigger CGU that includes the individual assets and the smaller CGUs is tested for impairment. Management should compare the recoverable amount of the bigger CGU with its carrying amount that is reduced by the impairment loss already recognised in step 1. The second step may not result in the recognition of additional impairment.

Question 16

Management uses key assumptions to assess the recoverable amount (ie, VIU or FVLCTS) of a CGU to which significant goodwill has been allocated. Should information be disclosed in the financial statements on the key assumptions that management selected even if no impairment is recognised?

Answer 16

Yes. Management must disclose how the recoverable amount was estimated – ie, whether VIU or FVLCTS. If the VIU was used, the following information should be disclosed:

- description of each key assumption underlying the cash flow projections, and management's approach to determine it;
- the period over which management has projected cash flows (when greater than five years, reasons why that longer

period is justified);

- the growth rate used to extrapolate cash flows; and
- the discount rate applied to the cash flow projections.

If FVLCTS was used, the methodology used to determine it should be disclosed. When the FVLCTS is not determined based on market prices, the following information must also be disclosed:

- a description of each key assumption used and management's approach to determining the key assumptions; and
- whether the assumptions are consistent with past experience or external data and if not, why not.

The information is therefore essentially the same as that required for VIU.

Question 17

Management uses key assumptions to assess the recoverable amount (ie, VIU or FVLCTS) of a CGU that includes a significant

acquired brand with an indefinite useful life. Management projects significant growth for the business in excess of that predicted by markets analysts. Management concludes that no impairment charge should be recognised. What information should be disclosed in the financial statements on the key assumptions that management selected?

Answer 17

In addition to the information of the key assumptions to assess the recoverable amount, management should disclose the following information if a reasonably possible change in a key assumption underlying FVLCTS or VIU would cause an impairment to arise (IAS 36.134(f)):

- the amount by which the CGU recoverable amount exceeds its carrying amount;
- the value assigned to the key assumption; and
- the amount by which the value assigned to the key assumption must change in order for the CGU recoverable amount to be equal to its carrying amount.

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