

IMPAIRMENT OF ASSETS (LECTURE A633 – 11.28 MINUTES)

One of the implicit rules in financial reporting is that assets should not be carried in the balance sheet in excess of recoverable amount. The term 'recoverable amount' is defined in the Glossary to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* as:

*'The higher of an **asset's** (or **cash-generating unit's**) fair value less costs to sell and value in use.'*

FRS 102 Glossary
**recoverable
amount**

FRS 102 (March 2018) deals with impairment of assets in Section 27 *Impairment of Assets*. The scope paragraph of Section 27 was condensed during the FRC's triennial review essentially to remove the definition of an impairment loss. Paragraph 27.1 of the March 2018 edition of FRS 102 now confirms that Section 27 applies to the impairment of assets and the recognition of impairment losses. Section 27 does not apply to:

- (a) **assets** arising from **construction contracts** (see Section 23 Revenue);
- (b) **deferred tax assets** (see Section 29 Income Tax);
- (c) assets arising from **employee benefits** (see Section 28 Employee Benefits);
- (d) **financial assets** within the scope of Section 11 Basic Financial Instruments or Section 12 Other Financial Instruments Issues;
- (e) **investment property** measured at **fair value** (see Section 16 Investment Property);
- (f) **biological assets** related to **agricultural activity** measured at fair value less estimated costs to sell (see Section 34 Specialised Activities); and
- (g) **deferred acquisition costs** and **intangible assets** arising from contracts within the scope of **FRS 103**.'

FRS 102 paragraph
27.1(a) to (g)

Applying the scope of Section 27, the following types of assets would be included:

- intangible assets including goodwill;
- tangible fixed assets;
- stock and work in progress;
- investments in subsidiaries measured at cost in the separate financial statements;
- investments in associates and joint ventures carried at cost;
- assets obtained by a lessee under a finance lease, or a lessor under an operating lease.

1.1 Stock and work in progress

Stock and work in progress (referred to as 'inventories' in FRS 102) must be assessed for impairment at each reporting date. This is done by comparing the

carrying amount of each item of inventory (or groups of similar items) with its selling price less costs to complete and sell (which used to be called 'net realisable value' under previous UK GAAP). Inventory is impaired when its estimated selling price less costs to complete and sell is lower than cost and a write-down to estimated selling price would be needed to comply with FRS 102 principles.

Paragraph 27.3 of FRS 102 states that where it is impracticable to determine the selling price less costs to complete and sell for inventories on an item by item basis, the entity may group items of inventory relating to the same product line which have similar purposes or end uses and are produced and marketed in the same geographical area for the purpose of assessing impairment.

The term 'impracticable' is defined in the Glossary to FRS 102 as follows:

'Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.'

FRS 102 Glossary
impracticable

Example – Sale after the balance sheet date (1)

Computers R Us Ltd has a batch of computer components with a cost price of £5,000 in inventory as at 31 July 2018 (the company's year-end). These components were used in a model of laptop computer which the company has discontinued manufacturing. A competitor has said that they will buy the components from the company at a price of £3,500 because they can use them. Computers R Us have agreed to the sale which took place on 20 August 2018.

A sale after the balance sheet date which is at a lower price than cost would generally indicate that there is evidence that fair value less costs to sell and complete is lower and hence a write-down of this inventory of £1,500 (£5,000 - £3,500) would be required.

Example – Sale after the balance sheet date (2)

Computers R Us Ltd has a batch of computer components with a cost price of £5,000 in inventory as at 31 July 2018 (the company's year-end). On 16 August 2018, damage was caused to these components by an employee meaning that they could not be used in the manufacturing process. A competitor has said that they will buy the components from the company at a price of £3,500 because they can use them. Computers R Us have agreed to the sale which took place on 20 August 2018.

Selling price became lower than cost on 16 August 2018 when the damage to the components happened. This happened after the year-end of 31 July 2018, hence the conditions giving rise to the impairment did not exist at the year-end and the loss in value should not be accounted for until the next accounting period. If the directors assess that the components could be sold (undamaged) for an amount at, or in excess of, the cost of £5,000 plus any costs to complete the sale, then no write-down would be required as at 31 July 2018.

Impairment reversals for inventory

At each balance sheet date, management are to make a new assessment of selling price less costs to complete and sell. When the circumstances which gave rise to the original impairment loss no longer exist, or there is clear evidence of an increase in selling price less costs to complete and sell, the entity must reverse the amount of the impairment. The reversal is **limited to the amount of the original impairment loss** so that the new carrying amount is at the lower of cost and the revised selling price less costs to complete and sell.

1.2 Impairment of assets other than inventories

Paragraph 27.5 of FRS 102 (March 2018) states:

FRS 102 para 27.5

*'If, and only if, the **recoverable amount** of an asset is less than its carrying amount, the entity shall reduce the carrying amount of the asset to its recoverable amount. That reduction is an impairment loss. Paragraphs 27.11 to 27.20A provide guidance on measuring recoverable amount.'*

The impairment loss referred to in paragraph 27.5 of FRS 102 is recognised immediately in profit and loss. Where the asset is measured at revaluation, the impairment loss is taken to the revaluation reserve (to the extent of a surplus on the revaluation reserve in respect of that asset), with any excess being taken to profit and loss.

In respect of revalued assets, the impairment requirements are somewhat different than under previous UK GAAP. FRS 11 *Impairment of fixed assets and goodwill* required an impairment loss on a revalued fixed asset to be recognised directly in profit and loss where it was caused by a clear consumption of economic benefits (i.e. through use). FRS 102 does not contain such a requirement and hence it may not be the case that where the asset is measured under the revaluation model, that the entire impairment loss is recognised immediately in profit and loss. It should, instead, be recognised in the revaluation reserve unless (or until) the impairment loss(es) exceed the surplus on the revaluation reserve for that asset.

1.3 Indicators of impairment

FRS 102 does not mandate an entity to determine recoverable amounts for assets and compare this to respective carrying values each year. Instead, it requires an entity to assess, at each balance sheet date, whether there is any indication that an asset may be impaired. Where such indicators exist, the entity then estimates recoverable amount. Where there is no indicator that an asset is impaired, it is not necessary to estimate recoverable amount.

Paragraph 27.8 of FRS 102 then goes on to state that where it is not possible to estimate the recoverable amount of an individual asset, the entity estimates the recoverable amount of the cash-generating unit to which the asset belongs. The paragraph then goes on to clarify that an asset's 'cash-generating unit' is the smallest identifiable group of assets that includes the asset and generates cash

inflows which are largely independent of the cash inflows from other assets or groups of assets.

There are two sources of information which FRS 102 requires an entity to consider when assessing if there is any indication that an asset may be impaired:

- external sources of information; and
- internal sources of information.

External sources of information

'During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.'

FRS 102 para 27.9(a)

This could be caused by a general decrease in market values of similar types of assets (for example where property prices decline).

FRS 102 para 27.9(b)

'Significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.'

This could arise due to an introduction in new legislation which bans the use of certain products which the entity may manufacture or where a product becomes obsolete due to competitors' introducing better products in the marketplace.

FRS 102 para 27.9(c)

*'Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect materially the discount rate used in calculating an asset's **value in use** and decrease the asset's **fair value less costs to sell**.'*

It may be appropriate to revisit the calculation used previously where an asset has been subjected to an impairment test where an interest rate has increased and could materially affect the discount rate which was used in that calculation. It should be noted that the review itself should only be carried out if the change in interest rates would affect the recoverable amount **materially**.

FRS 102 para 27.9(d)

'The carrying amount of the net assets of the entity is more than the estimated fair value of the entity as a whole (such an estimate may have been made, for example, in relation to the potential sale of part or all of the entity).'

A businesses' share price may have fallen due to varying degrees of factors and while this, in itself, may not necessarily give rise to an impairment loss being recognised, a formal review for impairment should be carried out by management. Care should also be taken to ensure that the discount rate used to calculate value in use is consistent with current market assessments.

Internal sources of information

FRS 102 para 27.9(e)

'Evidence is available of obsolescence or physical damage of an asset.'

When an asset becomes obsolete or there is physical damage to the asset, this is an indicator that the asset is showing signs of impairment. For example, a motor vehicle which has been damaged in a car accident or damage to an item of machinery in the production department.

FRS 102 para 27.9(f)

*'Significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the **useful life** of an asset as finite rather than indefinite.'*

Such significant changes may result in the asset becoming idle due to a restructuring exercise carried out by the entity (such as discontinuing a manufacturing line) and this may trigger the entity to try and dispose of the asset before they originally planned, due to it becoming 'out of service'. This will provide evidence that the asset is impaired and may need writing down to recoverable amount.

FRS 102 para 27.9(g)

'Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected. In this context economic performance includes operating results and cash flows.'

This could arise where maintenance costs for an asset are budgeted to be higher than originally planned.

1.4 Fair value less costs to sell and value in use

The recoverable amount of an asset (or cash-generating unit) is the **higher** of its fair value less costs to sell and its value in use. When it is not possible to estimate the recoverable amount of an individual asset, the asset's cash-generating unit is used instead.

FRS 102 acknowledges that it is not always necessary to determine *both* an asset's fair value less costs to sell and its value in use. If either of these amounts are in excess of the asset's carrying amount, the asset is not impaired and hence it is not necessary to determine the other amount.

The recoverable amount of an asset is essentially its contribution to future cash flows for the entity. This can either arise from selling the asset at current market price or at 'fair value less costs to sell' or through continuing use of the asset.

Paragraph 27.14 of FRS 102 provides the following sources of evidence (in descending order) of fair value less costs to sell:

- a price in a binding sale agreement in an arm's length transactions which is adjusted for directly attributable costs of disposal;

- the bid price in an active market less the costs of disposal. If current bid prices are not available, the price of the most recent transaction may provide a basis on which to estimate fair value less costs to sell (where there has been no significant change in economic circumstances between the date of the transaction and the estimation date); and
- the best information available to reflect the amount which the entity could obtain (at the end of the reporting period) for the disposal of the asset in an arm's length transaction after deducting the disposal costs.

The entity must also consider any restrictions which are imposed on the asset according to paragraph 27.14A of FRS 102. Costs to sell (see below) must include the cost of obtaining relaxation of a restriction, where necessary, in order to enable the asset to be sold. If a restriction would also apply to any potential purchaser of an asset, the fair value of the asset may be lower than that of an asset whose use is not restricted.

Costs to sell

Costs to sell would usually include:

- legal costs;
- stamp duty and similar transaction taxes;
- removal costs; and
- other directly attributable (incremental) costs associated with bringing the asset into the condition expected for the sale to complete.

Value in use

Value in use calculations are inherently complex and, in practice, fair value less costs to sell is often the simpler value to use for the purposes of impairment testing.

The term 'value in use' refers to the present value of the future cash flows which are expected to be derived from an asset.

Paragraph 27.15 of FRS 102 requires the following steps to be used in the present value calculation:

- (a) estimate the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal; and
- (b) apply the appropriate discount rate to those future cash flows.

Calculating an asset's value in use requires the following elements to be reflected:

- (a) *an estimate of future cash flows the entity expects to derive from the asset;*
- (b) *expectations about possible variations in the amount or timing of those future cash flows;*
- (c) *the time value of money, represented by the current market risk-free rate of interest;*
- (d) *the price for bearing the uncertainty inherent in the asset; and*

FRS 102 para
27.16(a) to (e)

- (e) *other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.'*

Estimates of future cash flows in (a) above would include:

- projections of cash inflows by the entity continuing to use the asset;
- projections of cash outflows necessary to generate the cash inflows from continuing use; and
- net cash flows (if any) which are expected to be received (or paid) for the disposal of the asset at the end of its useful life in an arm's length transaction between knowledgeable and willing parties.

Such future cash flows could be derived from budgets or forecasts. However, they should not include cash inflows or outflows from financing activities (e.g. interest) or income tax receipts or payments.

The future cash flows are to be estimated for the asset in its **current** condition and must not include cash inflows or outflows which are expected to arise from:

- a future restructuring which has not yet been carried out; or
- improving or enhancing the asset's performance.

The discount rate above should be:

- a pre-tax rate(s) which reflect 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 estimated.

This information is unlikely to be available for individual assets due to the unique nature of different transactions as well as the fact that few listed entities offer a readily usable comparison.

The discount rate(s) used to measure an asset's value in use must not reflect risks for which the future cash flow estimates have been adjusted so as to avoid double-counting.

Where an asset is being held for its service potential, FRS 102 clarifies that a cash-flow driven valuation (e.g. value in use) may be inappropriate. Value in use for such assets is determined by the present value of the asset's remaining service potential plus the *net* amount the entity would receive from its disposal. In some cases, this may be taken to be costs avoided by possession of the asset and so the standard suggests that depreciated replacement cost may be a suitable measurement model.

1.5 Recognition of an impairment loss

An impairment loss is to be allocated in the following order:

- first, reduce the carrying amount of any goodwill allocated to the cash-generating unit; then
- allocate the balance to the remaining assets of the unit on a pro-rata basis of the carrying amount of each asset in the cash-generating unit.

Paragraph 27.22 of FRS 102 restricts the amount by which an asset in a cash-generating unit can be reduced by. This paragraph states that an entity must not reduce the carrying amount of any asset in the cash-generating unit below the highest of:

- fair value less costs to sell (where determinable);
- value in use (where determinable); and
- zero.

Any excess amount which cannot be allocated to an asset because of the above restriction is allocated to the other assets of the unit pro-rata on the basis of the carrying amount of those other assets.

This allocation is different than previous UK GAAP. Previous FRS 11 allocated an impairment loss first to any goodwill, then any intangible assets and then to tangible fixed assets.

1.6 Goodwill impairment

There are specific rules in FRS 102 relating to goodwill at paragraphs 27.24 to 27.27.

The first point to emphasise is what where goodwill has been written down by way of an impairment loss, the write-down must not be reversed in a subsequent period. This is to reflect the provisions of the EU Accounting Directive and also makes FRS 102 consistent with IAS 36 *Impairment of Assets*.

For non-wholly-owned subsidiaries, part of the recoverable amount of a cash-generating unit will be attributable to the non-controlling interests (NCI). During the impairment test, paragraph 27.26 of FRS 102 requires the carrying amount of that unit to be notionally adjusted before being compared with its recoverable amount. This is done by grossing up the carrying amount of

goodwill which is allocated to the cash-generating unit to include goodwill attributable to the NCI. This notionally adjusted amount is then compared to recoverable amount to determine whether the CGU is impaired.

Example – Notional adjustment for goodwill

Holdco Ltd acquires an 80% ownership interest in Subco for £100,000. At the date of acquisition, Subco's net assets had a fair value of £75,000 and hence goodwill was recognised of £40,000 (£100,000 – (£75,000 x 80%)). For the purpose of impairment testing the goodwill on acquisition of Subco, the goodwill of £40,000 is grossed-up to £50,000 (£40,000 x 100/80). This grossed-up amount is then aggregated with the other net assets and compared with the CGU's recoverable amount to ascertain any impairment amount.

1.7 Reversals

As noted in 4.6 above, impairment losses in respect of goodwill must not be subsequently written back. Once an impairment loss has been recognised for goodwill, it stays as a loss.

In respect of all other assets, previously recognised impairment losses can be recognised if, and only if, the reasons for the impairment loss cease to apply.

It will be necessary to determine whether the previously recognised impairment loss was based on:

- (a) the recoverable amount of an individual asset; or
- (b) the recoverable amount of the cash-generating unit to which the asset belongs.

Recoverable amount based on the amount of an individual asset

Where recoverable amount was based on the amount of an individual asset, the following requirements will apply:

- (a) *The entity shall estimate the recoverable amount of the asset at the current reporting date.*
- (b) *If the estimated recoverable amount of the asset exceeds its carrying amount, the entity shall increase the carrying amount to recoverable amount, subject to the limitation described in (c) below. That increase is a reversal of an impairment loss. The entity shall recognise the reversal immediately in profit or loss unless the asset is carried at revalued amount in accordance with another section of this FRS (for example, the revaluation model in Section 17 Property, Plant and Equipment). Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with the relevant section of this FRS.*
- (c) *The reversal of an impairment loss shall not increase the carrying amount of the asset above the carrying amount that would have been*

FRS 102 para
27.30(a) to (d)

determined (net of amortisation or depreciation) had no impairment been recognised for the asset in prior years.

- (d) *After a reversal of an impairment loss is recognised, the entity shall adjust the depreciation (amortisation) charge for the asset in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.'*

Example – Reversal of an impairment loss

An intangible asset is purchased for £50,000 and is being amortised on a straight-line basis over 20 years. Three years after it has been purchased, it becomes impaired and is written down from its carrying amount of £45,000 to £30,000. Two years after the impairment loss, carrying amount is £26,250 ($(£30,000 / 16 \text{ years}) \times 2 - £30,000$), the recoverable amount of the intangible asset is estimated to be £40,000 as the circumstances giving rise to the original impairment loss have ceased to apply.

As the circumstances giving rise to the original impairment loss have ceased to apply, the impairment loss is reversed. However, the impairment loss can only be reversed to the extent that it does not increase the carrying amount of the intangible asset to what it would have been had no impairment previously been recognised. Had the impairment never occurred, the carrying amount would be £37,500 ($£50,000 - (£2,500 \times 5)$). Therefore, not all of the original £15,000 impairment loss can be reversed (only £13,750 can be reversed being £37,500 carrying value to date pre impairment loss, less £26,250 carrying value post impairment loss). The difference is the amount of amortisation that would have been charged had the impairment loss not been recognised. The effect of the above is shown below:

	No Impairment	Impairment
	£	£
Cost at 1 January 2018	50,000	50,000
Year 1	(2,500)	(2,500)
Year 2	(2,500)	(2,500)
End of year 2	45,000	45,000
Year 3	(2,500)	(15,000)
Carrying value	42,500	30,000
Year 4	(2,500)	(1,875)*
Year 5	(2,500)	(1,875)
	37,500	26,250
Recoverable amount	40,000	40,000
Difference	2,500	13,750

Original impairment	15,000
Amount of reversal	<u>13,750</u>
Difference	1,250
*(£30,000/16 years)	

The difference above of £1,250 is the difference between the amortisation charge which would have been recognised had no impairment loss been recorded, i.e. £5,000 (£2,500 x 2) and the amortisation charge that has been recognised following the impairment loss of £3,750 (£1,875 x 2).

Recoverable amount estimated for a cash-generating unit

When the original impairment loss was based on the recoverable amount of the cash-generating unit to which the asset, including goodwill belongs, the following requirements apply according to paragraph 27.31 of FRS 102:

- (a) *The entity shall estimate the recoverable amount of that cash-generating unit at the current reporting date.*
- (b) *If the estimated recoverable amount of the cash-generating unit exceeds its carrying amount, that excess is a reversal of an impairment loss. The entity shall allocate the amount of that reversal to the assets of the unit, except for goodwill, pro rata with the carrying amounts of those assets, subject to the limitation described in (c) below. Those increases in carrying amounts shall be treated as reversals of impairment losses and recognised immediately in profit or loss unless an asset is carried at revalued amount in accordance with another section of this FRS (for example Section 17 Property, Plant and Equipment). Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with the relevant section of this FRS.*
- (c) *In allocating a reversal of an impairment loss for a cash-generating unit, the reversal shall not increase the carrying amount of any asset above the lower of:*
 - (i) *its recoverable amount; and*
 - (ii) *the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.*
- (d) *Any excess amount of the reversal of the impairment loss that cannot be allocated to an asset because of the restriction in (c) above shall be allocated pro rata to the other assets of the cash-generating unit, except for goodwill.*
- (e) *After a reversal of an impairment loss is recognised, if applicable, the entity shall adjust the depreciation (amortisation) charge for each asset in the cash-generating unit in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.'*

FRS 102 para
27.31(a) to (e)

Applying the above paragraphs mean that the reversal of any impairment loss will be allocated only between those assets to which the original impairment loss was allocated (although not necessarily in the same proportions as the loss was originally allocated). Where this results in a reversal being allocated to an asset which is less than its pro-rata share of the reversal, the amount of the impairment reversal which would otherwise have been allocated to the asset should be allocated to other assets of the unit (but not goodwill), on a pro-rata basis.

1.8 Disclosure requirements

The disclosure requirements in respect of asset impairment are outlined in paragraphs 27.32 to 27.33A of FRS 102 and are as follows:

FRS 102 para 27.32

*'An entity shall disclose the following for each **class of assets** indicated in paragraph 27.33:*

- (a) the amount of impairment losses recognised in profit or loss during the period and the line item(s) in the **statement of comprehensive income** (or in the **income statement**, if presented) in which those impairment losses are included; and*
- (b) the amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) in the statement of comprehensive income (or in the income statement, if presented) in which those impairment losses are reversed.*

FRS 102 para 27.33

An entity shall disclose the information required by paragraph 27.32 for each of the following classes of asset:

- (a) inventories;*
- (b) **property, plant and equipment** (including investment property accounted for by the cost method);*
- (c) goodwill;*
- (d) intangible assets other than goodwill;*
- (e) investments in **associates**; and*
- (f) investments in **joint ventures**.'*

FRS 102 para 27.33A

An entity shall disclose a description of the events and circumstances that led to the recognition or reversal of the impairment loss.'