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LKAS 36 : Impairment of Assets

Chartered Accountancy
Corporate Level
Financial Reporting and Governance (FRG)

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LKAS 36 – IMPAIRMENT

- ✓ Impairment = CV – RV
- ✓ RV = Higher of Value in Use and FV- Cost to Sell
- ✓ Value in Use: ***(ENCF from the Asset x DCF relevant to the asset)***

1. points shall consider when measuring value in use – para 30
2. points shall consider when estimating future cash flows – para 33
3. cash flows will include – para 39
4. cash flows shall not include – para 44 & 50
5. How to determine the DCF – para 55 & A17/A18

- ✓ FV – Cost to Sell

1. FV shall be considered according to SLFRS 13
2. Cost to sell – Para 28

- ✓ Accounting for Impairment

1. For individual asset - Dr. P/L
Cr. Asset
2. For Group of Assets and liabilities (CGU)
Dr. P/L
Cr.
    - a. not credited to assets under para 02
    - b. credit into assets destroyed
    - c. credit to assets already agreed to sell
    - d. credit to goodwill
    - e. allocate balance loss among all remaining assets on pro-rata basis

- ✓ Impairment requirement

  1. Goodwill on acquisition/ Intangible assets with infinite lifetime / intangible assets not yet started to use shall test for impairment every year end even indication of impairment exits or not.

  2. all other assets will test for impairment if there is an indication only.

- ✓ Indications of impairment – para 12

Learning objectives

- Discuss what an impairment is.
- Explain the conditions of impairment (how to identify an asset that may be impaired).
- Assess the recoverable amount of an asset (value in use and fair value less costs to sell).
- Explain the basis to be used to estimate future cash flows in determining value in use.
- Discuss how to measure the recoverable amount of an intangible asset with an indefinite useful life.
- Assess the recoverable amount and carrying amount of a cash-generating unit.
- Compute the impairment loss of an individual asset and a cash-generating unit.
- Explain the reversing of an impairment loss of an individual asset, goodwill and a cash-generating unit.
- Compute the impairment loss to be reversed for an individual asset, goodwill and a cash-generating unit.
- Outline the disclosures to be made in respect of impairment of assets.

Introduction

Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. This is the higher of its fair value less costs of disposal and its value in use. (Impairment = CV – RV)

31 March 2021

Statement of Financial Position (Rs)

	Cost/RV	Acc. Dep.	CV
Non-Current Assets			
PPE			
Land & Buildings	100,000	20,000	80,000

(Higher value) Recoverable Value

Rs. 70,000/-

Value In Use

Rs. 70,000/-

FV – Cost to Sell

Rs. 65,000/-

IMPAIRMENT LOSS

Rs. 10,000/-

Question 01

Canto acquired a cash-generating unit (CGU) several years ago but, at 28 February 2017, the directors of Canto were concerned that the value of the CGU had declined because of a reduction in sales due to new competitors entering the market. At 28 February 2017, the carrying amounts of the assets in the CGU before any impairment testing were:

	($m)
Goodwill	3
Property, plant and equipment	10
Other assets	19
Total	32

The fair values of the property, plant and equipment and the other assets at 28 February 2017 were $10 million and $17 million respectively and their costs to sell were $100,000 and $300,000 respectively.

The CGU's cash flow forecasts for the next five years are as follows:

Date year ended	Pre-tax cash flow ($m)	Post-tax cash flow ($m)
28 February 2018	8	5
28 February 2019	7	5
28 February 2020	5	3
28 February 2021	3	1·5
28 February 2022	13	10

The pre-tax discount rate for the CGU is 8% and the post-tax discount rate is 6%. Canto has no plans to expand the capacity of the CGU and believes that a reorganisation would bring cost savings but, as yet, no plan has been approved.

The directors of Canto need advice as to whether the CGU's value is impaired.

The following extract from a table of present value factors has been provided.

Year	Discount rate 6%	Discount rate 8%
1	0·9434	0·9259
2	0·8900	0·8573
3	0·8396	0·7938
4	0·7921	0·7350
5	0·7473	0·6806

Required:

Advise the directors of Canto on how the above transactions should be dealt with in its financial statements with reference to relevant International Financial Reporting Standards.

ANSWER

As per LKAS 36, the impairment is the excess of it carrying value over the Recoverable value. (Impairment = CV – RV)

Recoverable value is the higher of its Fair value less cost to disposal and value in use.

Therefore, we can compute the impairment of said CGU as follows,

FV- Cost to disposal

Asset	FV	Cost to Disposal	FV- Cost to Disposal
Goodwill	-	-	-
PPE	10mn	0.1mn	9.9mn
Other Assets	17mn	0.3mn	16.7mn
Total	**27mn**	**0.4mn**	**26.6mn**

Value In USE

As per the standard the value in use will be considered after getting the future expected net cash flows from the existing asset with relevant discounting factor. Importantly we required to consider pre-tax cash flow and pre-tax dcf.

Year	NCF	DCF 8%	PV
28 February 2018	8	0.926	
28 February 2019	7	0.857	
28 February 2020	5	0.794	
28 February 2021	3	0.735	
28 February 2022	13	0.681	
Total PV			**28.43mn**

According to the computation the recoverable value will be $ 28.43mn and the expected impairment would be (32mn - 28.43mn) $3.57mn.

Impairment loss identified above will be recorded as follows, (loss 3.57mn)

Dr. P/L

Cr. a. not credited to assets under para 02

b. credit into assets destroyed

c. credit to assets already agreed to sell

d. credit to goodwill

e. allocates balance loss among all remaining assets on pro-rata basis

Assets	CV before impairment	impairment	CV after impairment
Goodwill	3	(3)	0
PPE	10	(0.20)	9.80
Other Assets	19	(0.37)	18.63
	$ 32mn	($ 3.57mn)	$28.43mn

Dr, P/L 3.57

Cr. Goodwill 3

PPE 0.20

Other assets 0.37

Question 02

Pod has a significant network of retail branches. In its financial statements, Pod changed the determination of a cash generating unit (CGU) for impairment testing purposes at the level of each major product line, rather than at each individual branch. The determination of CGUs was based on the fact that each of its individual branches did not operate on a standalone basis as some income, such as volume rebates, and costs were dependent on the nature of the product line rather than on individual branches. Pod considered that cash inflows and outflows for individual branches did not provide an accurate assessment of the actual cash generated by those branches. Pod, however, has daily sales information and monthly statements of profit or loss produced for each individual branch and this information is used to make decisions about continuing to operate individual branches.

Required:

Discuss whether the changes to accounting practice suggested by Pod are acceptable under International Financial Reporting Standards.

Question 03

An assessment of accounting practices for asset impairments is especially important in the context of financial reporting quality in that it requires the exercise of considerable management judgement and reporting discretion. The importance of this issue is heightened during periods of ongoing economic uncertainty as a result of the need for companies to reflect the loss of economic value in a timely fashion through the mechanism of asset write-downs. There are many factors which can affect the quality of impairment accounting and disclosures.

These factors include changes in circumstance in the reporting period the market capitalisation of the entity, the allocation of goodwill to cash generating units, valuation issues and the nature of the disclosures.

Required:

Discuss the importance and significance of the above factors when conducting an impairment test under IAS 36 Impairment of Assets.

Question 04

Estoil is an international company providing parts for the automotive industry. It operates in many different jurisdictions with different currencies. During 2014, Estoil experienced financial difficulties marked by a decline in revenue, a reorganisation and restructuring of the business and it reported a loss for the year. An impairment test of goodwill was performed but no impairment was recognised. Estoil applied one discount rate for all cash flows for all cash generating units (CGUs), irrespective of the currency in which the cash flows would be generated. The discount rate used was the weighted average cost of capital (WACC) and Estoil used the 10-year government bond rate for its jurisdiction as the risk free rate in this calculation.

Additionally, Estoil built its model using a forecast denominated in the functional currency of the parent company. Estoil felt that any other approach would require a level of detail which was unrealistic and impracticable. Estoil argued that the different CGUs represented different risk profiles in the short term, but over a longer business cycle, there was no basis for claiming that their risk profiles were different.

Required:

Discuss the acceptability of the above accounting practice under IAS 36 Impairment of Assets.

Answer

As per LKAS 36, The discount rate (rates) shall be a pre-tax rate (rates) that reflect(s) current market assessments of:

(a) the time value of money; and

(b) the risks specific to the asset for which the future cash flow estimates have not been adjusted

As a starting point in making such an estimate, the entity might take into account the following rates:

(a) the entity's weighted average cost of capital determined using techniques such as the Capital Asset Pricing Model;

(b) the entity's incremental borrowing rate; and

(c) other market borrowing rates.

However, these rates must be adjusted:

(a) to reflect the way that the market would assess the specific risks associated with the asset's estimated cash flows; and

(b) to exclude risks that are not relevant to the asset's estimated cash flows or for which the estimated cash flows have been adjusted.

Consideration should be given to risks such as country risk, currency risk and price risk.

In the given scenario the entity has used single DCF to discount cash flow estimated from assets which are in different jurisdictions. The risk associated with asset will change when the currency, price risk and exchange rates changing. Therefore, entity cannot use single DCF factor to discount cash flows of different jurisdiction.

Entity shall determine separate DCFs applicable for each asset which are in deferent jurisdictions. Entity requires to consider deferent country risk, price risk, exchange risk and other micro economic variables when estimate the DCF for each asset.

Question 05

Fariole specialises in the communications sector with three main CGUs. Goodwill was a significant
component of total assets. Fariole performed an impairment test of the CGUs. The cash flow projections were based on the most recent financial budgets approved by management. The realised cash flows for the CGUs were negative in 2014 and far below budgeted cash flows for that period. The directors had significantly raised cash flow forecasts for 2015 with little justification. The projected cash flows were calculated by adding back depreciation charges to the

budgeted result for the period with expected changes in working capital and capital expenditure not taken into account.

Required:

Discuss the acceptability of the above accounting practice under IAS 36 Impairment of Assets.

Answer

As per LKAS 36,

(a) Cash flow projections are based on 'reasonable and supportable' assumptions.

(b) Projections of cash flows, normally up to a maximum period of five years, are based on the most recent budgets or financial forecasts.

(c) A steady or declining growth rate for each subsequent year (unless a rising growth rate can be justified) is used in extrapolating short-term projections of cash flows beyond this period. Unless a higher growth rate can be justified, the long-term growth rate employed should not be higher than the average long-term growth rate for the product, market, industry or country.

Cash flows should include:

• Projected cash inflows from continuing use of the asset

• Projected cash outflows necessary to generate these cash inflows

• Net cash flows from the disposal of the asset at the end of its life

They should not include:

• Cash flows associated with a future restructuring to which an entity is not committed

• Cash flows associated with improving the asset's performance

• Cash flows from financing activities

• Income tax receipts or payments

According to given scenario entity used only little justification and not supported their projection by reasonable and supportable assumptions.

Further entity started the projection based on mgt approved recent budgets when actual for those far below. Entity requires to commence the projections from actual since budgeted figures were varying from actual.

However, elimination of depreciations was acceptable since it is not a cash outflow and not considering capital expenditure also acceptable since future restructuring cannot incorporate.

Question 06

PIN PLC has a cash generating unit, which was reviewed for impairment at 31 March 2014. The impairment review revealed that the cash generating unit had a value in use of Rs. 70 million and a fair value less costs to sell of Rs. 64 million. The carrying amount of the net assets of the cash generating unit immediately prior to the impairment review was as follows.

1. Inventory LKAS 2

2. CGU LKAS 36

	Rs. '000
Goodwill	16,000
Book value of property, plant and equipment	46,000
Net current assets	12,000
	74,000

There was no other evidence of obvious impairment to specific assets except for the obsolete stocks amounting to Rs. 2 million included in net current assets.

Determine the carrying amount of the goodwill relating to the cash generating unit immediately after the impairment review in accordance with LKAS 36 - Impairment of Assets. (6 marks)

ANSWER

Per LKAS 36, At the time of impairment testing a cash-generating unit to which goodwill has been allocated, there may be an indication of an impairment of an asset within the unit containing the goodwill. In such circumstances, the entity tests the asset for impairment first, and recognises any impairment loss for that asset before testing for impairment the cash-generating unit containing the goodwill.

In the given scenario the inventory shall test for its obvious impairment before testing for the CGU. Therefore, CV of net current assets before impairment of CGU would be 10,000 (12000 – 2000)

The impairment loss on CGU can be allocated as follows,

Asset	CV before the Impairment of CGU	Impairment	CV after the Impairment of CGU
Goodwill	**16000**	**(2000)**	**14000**
PPE	**46000**	**-**	**46000**
Net Current Assets	**10000**	**-**	**10000**

	72000	**(2000)**	**70000**

Impairment of Inventory As per LAKS 2 **dr. P/l 2000**
Cr. Inventory 2000

Impairment of CGU as per LKAS 36 **dr. P/l 2000**
Cr. goodwill 2000

Question 08

You are the accountant of Zigma PLC. The company's main business is to manufacture plastic household items. In recent years, sales were severely affected due to propaganda on the use of environment friendly household items and the products available in the market due to superior technology used by competitors. The company had planned a major overhaul of its plant that produces one of its fast-moving items, but such plans were deferred due to restrictions on capital expenditure. As such, the plant is currently operating at 60% capacity.

(a) Prepare a suitable paper that describes indicators of impairment for the business line of manufacturing plastic household items and evaluate the indicators you identified considering the current circumstances described in the above scenario. (7 marks)

Indications of Impairment

- ✓ Customer attitudes changed due to propaganda on the use of environment friendly household.
- ✓ products available in the market due to superior technology used by competitors
- ✓ restrictions on capital expenditure for new investments to recover the business
- ✓ plant is currently operating at 60% capacity – under utilization

(b) If you were requested to perform a Fair Value Less Costs to Sell for a cash generating unit explain the hierarchy you would follow in determining this value. (3 marks)

(Total 10 marks)

Alternative Question

AB plc has a CGU which was tested for impairment at 31/3/2020. CV of the CGU before impairment testing was,

Goodwill	**LKR 200mn**
PPE	**LKR 300mn -----250/-**
Investment property	**LKR 500mn ----480/-**
Intangible assets	**LKR 400mn**
Current Assets	**LKR 800mn**

Following information were revealed before the impairment.

1. One plant were revalued, and the revaluation loss was reported LKR 50mn. This plant was previously revalued and its gain of LKR 30 mn properly accounted for.

2. Entity policy is to measure Investment properties in FV. FV of Investment properties at 31.3.2020 were 480mn.

Recoverable value of the CGU was estimated to LKR 1500mn at 31.3.2020

ANSWER

The plant and the investment property shall report in to their cv according to the LKAS 16 & LKAS 40 respectively.

1. Revaluation loss of the plant can be adjusted according to LKAS 16. Existing revaluation loss shall charge initially to previously identified gains in the equity.

Dr. Revaluation reserve	30
Dr. p/l	20
Cr. PPE	50

2. As per LAKS 40 FV loss at subsequent measurement shall charge to p/l

Dr. p/l	20
Cr. Investment Property	20

Now we can identify the impairment of CGU as per LKAS 36.

After the obvious impairment of PPE & IP, the CV of CGU before its impairment is:

Goodwill	**LKR 200mn**
PPE	**LKR 250mn**
Investment property	**LKR 480mn**
Intangible assets	**LKR 400mn**
Current Assets	**LKR 800mn**
	2130mn

	CV before impairment of CGU	Impairment of CGU	CV after Impairment of CGU
Goodwill	**200mn**	(200)	
PPE	**250mn**	(165)	
Investment property	**480mn**	N/A	
Intangible assets	**400mn**	(265)	
Current Assets	**800mn**	N/A	
	2130	(630)	1500

Example: recognition of impairment loss

Fernando Property (Pvt) Ltd acquired a property on 1 January 20X4 at a cost of Rs. 8m and commenced depreciation over a 50-year useful life from this date. The company applied the LKAS 16 revaluation model for the subsequent accounting of the property, and revalued it for the first time to Rs. 8,544,000 at 31 December 20X5, continuing to depreciate it over the original term. During 20X6 there was a commercial property crash, and as a result the recoverable amount of the property fell to Rs. 7.4m at 31 December 20X6. Fernando Property do not make an annual reserves transfer in respect of revalued property.

Required

Demonstrate how the impairment at 31 December 20X6 is accounted for.

Answer	LKR 000'
1 Jan 2014 cost	8000
(-) acc. Dep for 2 years (8000/50 x 2)	(320)
CV at 31 Dec 2015	7680
Revaluation gain	864
Revaluation	8544
(-) dep 2016 - (8544/48)	(178)
CV at 31 Dec 2016	8366
Impairment of the Property	(966)
Recoverable value 31 Dec 2016	7400

Dr. Property 864
Cr. OCI 864

Dr. Revaluation reserve 864
Dr. P/L 102
Cr. Property 966

Reversal of an impairment loss

A cash-generating unit comprising assets and associated purchased goodwill becomes impaired because the product it makes is overtaken by a technologically more advanced model produced by a competitor. The recoverable amount of the cash-generating unit falls to Rs. 80m, resulting in an impairment loss of Rs. 60m, allocated as follows.

	Carrying amount before impairment	*Carrying amount after impairment*
	Rs Mn	Rs Mn
Goodwill	40	–
Current assets	20	20
Tangible non-current assets (market value Rs. 60m)	80	60
Total	140	80

After two years, the entity makes a technological breakthrough of its own. At this time the carrying amount of the tangible non-current assets of the CGU is Rs. 48m and the carrying amount of current assets is Rs. 25m and the recoverable amount of the cash-generating unit increases to Rs. 90m. The carrying amount of the tangible non-current assets had the impairment not occurred would have been Rs. 64m.

Required

Calculate the reversal of the impairment loss.