

QUESTION SIX

- a) Carbot plc has just suffered a major loss of key employees. Two directors have gone to work for a rival company and as a result the Board of Directors has committed Carbot to a major reorganisation. The directors are worried that the company may experience significant impairment charges, but are unsure how they should test for impairment and what other considerations should be taken into account.

Required :

Discuss the main considerations that the company should take into account when testing for impairment of fixed assets in the current economic environment.

(9 marks)

- b) There is a specific property on which the company wishes to seek advice. Carbot purchased the property for £800,000 on 1 January 2006 which then had an expected useful life of 30 years. On 31 December 2009 it was revalued to £950,000 and its remaining useful life was estimated to be 22 years. On 31 December 2012 an impairment review was carried out and the projected cash flows were as follows:

	31 December	31 December	31 December	31 December
Year to	2013	2014	2015	2016
Cash flows	£140,000	£110,000	£100,000	£90,000

The appropriate discount ratio is 5%. Net realisable value at 31 December 2012 is £475,000. On 20 May 2013 the directors used the same cash flow projections and noticed that the resultant value in use was above the carrying amount of the assets and wished to reverse any impairment loss calculated at 31 December 2012.

Discount factors at 5% are as follows:

Year	PV factor @ 5%
1	0.9524
2	0.9070
3	0.8638
4	0.8227

Required :

Discuss, with suitable computations, how to account for any potential impairment of the revalued property in the accounts for the year ended 31 December 2012.

(11 marks)**(TOTAL 20 MARKS)**

QUESTION FIVE

Answer

a) FRS 11 *Impairment of fixed assets and goodwill*, states that an asset is impaired when its carrying amount will not be recovered from its continuing use or from its sale. An entity must determine at each reporting date whether there is any indication that an asset is impaired. If an indicator of impairment exists then the asset's recoverable amount must be determined and compared with its carrying amount to assess the amount of any impairment. The turbulence in the markets and signs of economic downturn are an obvious indicator of impairment, which may cause the entity to experience significant impairment charges.

Assets should be tested for impairment at as low a level as possible, at individual asset level where possible. However, many assets do not generate cash inflows independently from other assets and such assets will usually be tested within the income-generating unit (IGU) to which the asset belongs. Cash flow projections should be based on reasonable assumptions and the discount rate used is the rate which reflects the specific risks of the asset or IGU.

The basic principle is that an asset may not be carried in the balance sheet at more than its recoverable amount. An asset's recoverable amount is the higher of:

- i) The amount for which the asset could be sold in an arm's length transaction between knowledgeable and willing parties, net of costs of disposal (fair value less costs to sell); and
- ii) The present value of the future cash flows that are expected to be derived from the asset (value in use). The expected future cash flows include those from the asset's continued use in the business and those from its ultimate disposal. Value in use (VIU) is explicitly based on present value calculations.

This measurement basis reflects the economic decisions that a company's management team makes when assets become impaired from the viewpoint of whether the business is better off disposing of the assets or continuing to use it.

(B)

For a revalued asset, FRS 11 distinguishes 2 types of impairment:

- an impairment from a clear consumption of economic benefits
- other impairments of revalued fixed assets (usually due to changes in price levels)

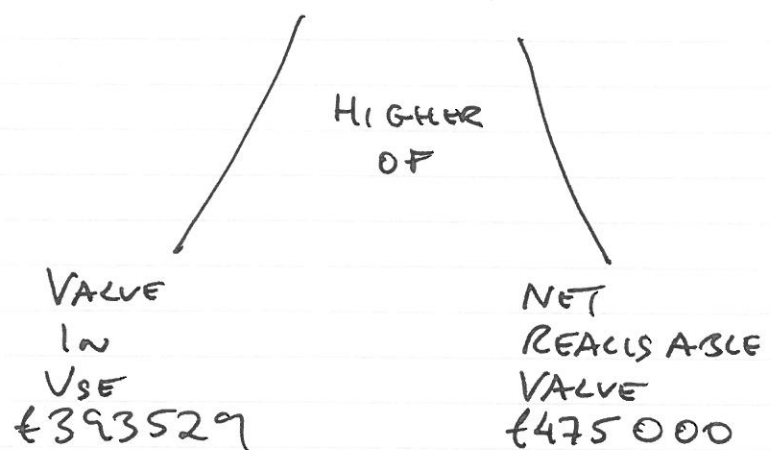
The first type should be recognised in the p+l a/c as it is effectively depreciation

The second type should be recognised in the revaluation reserve until the carrying amount reaches depreciated historical cost. Any balance of the loss is then treated as an expense in the p+l a/c.

CARRYING
VALUE
£820455

Vs

RECOVERABLE
AMOUNT



(W1) VALUE IN USE

TIME	CASH FLOW	PV FACTOR AT 5%	PV
1	140000	0.9524	133336
2	110000	0.9070	99770
3	100000	0.8638	86380
4	90000	0.8227	74043
NPV =			<u><u>393529</u></u>

$$\therefore \text{IMPAIRMENT LOSS} = 820455 - 475000$$

$$= \underline{\underline{£345455}}$$

DR	REVALUATION	RESERVE	221667 (820455 - 598788)
~~PLC~~	PLC A/C		123788
CR	FIXED ASSETS		345455

W2

	DEPRECIATED HISTORICAL COST £	REVALUED AMOUNT £
1-1-06	800000	800000
Depn to 31-12-09 ($800000 \div 30 \times 4 \text{ yrs}$)	(106667)	(106667)
REVALUATION	<u>693333</u>	<u>256667</u> 950000
Depn to 31-12-12 ($693333 \div 22 \times 3 \text{ yrs}$) ($950000 \div 22 \times 3 \text{ yrs}$)	(94545)	(129545)
CARRYING AMOUNT AT 31-12-12	<u><u>598788</u></u>	<u><u>820455</u></u>