

QUESTION FIVE

- a) Fortran plc is experiencing falling sales and asset prices. It has been unable to obtain a loan from its bank because of tightening of credit conditions. 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.

(10 marks)

- b) There is a specific asset on which the company wishes to seek advice. Fortran holds a property which was purchased for £900,000 on 1 January 2007 with an expected useful life of 20 years. On 1 January 2012 it was revalued to £800,000. On 31 December 2013 an impairment review was carried out and the projected cash flows were as follows:

	31 December	31 December	31 December	31 December
Year to	2014	2015	2016	2017
Cash flows	£120,000	£130,000	£110,000	£105,000

The appropriate discount ratio is 5%. Net realisable value at 31 December 2013 is £400,000.

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 2013.

(10 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 two types of impairment. These are impairments from a clear consumption of economic benefits and other impairments of revalued fixed assets. The former should be recognised in the profit and loss account as it is effectively depreciation, whilst other impairments 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 profit and loss account.

	Depreciated historical cost	Revalued carrying amount
1 January 2007	900,000	900,000
Depreciation to 1 January 2012 ($900,000 \div 20 \times 5$)	(225,000)	(225,000)
Revaluation	<u>675,000</u>	<u>125,000</u>
1 1/2		800,000
Depreciation to 31 December 2013 ($675,000 \div 15 \times 2$) ($800,000 \div 15 \times 2$)	(90,000)	(106,667)
1 1/2	<u>585,000</u>	<u>693,333</u>
Carrying amount 31/12/10		

The recoverable amount needs to be calculated and is the higher of:

i) The value in use

Year	Cash Flow	PV factor @ 5%	Discounted cash flow
1	120,000	0.9524	114,288
2	130,000	0.9070	117,910
3	110,000	0.8638	95,018
4	105,000	0.8227	86,383
			<u>413,599</u>

ii) Net realisable value
= 400,000

1 Recoverable amount 413,599

1 The impairment loss $693,333 - 413,599 = 279,734$

1 The amount charged to the revaluation reserve
is $693,333 - 585,000 = 108,333$

1 The remainder $279,734 - 108,333 = 171,401$ is
charged to the profit and loss account