

IMPAIRMENT (12/98, amended) ACCA

FRS 11 *Impairment of fixed assets and goodwill* was published in July 1998. Impairment is measured by comparing the value of a fixed asset with its recoverable amount. The issues of how one identifies an impaired asset, the measurement of an asset where impairment has occurred and the recognition of impairment losses are also dealt with in the standard.

Required

- (a) (i) Describe the circumstances which indicate that an impairment loss relating to a fixed asset may have occurred. (7 marks)
- (ii) Explain how FRS 11 deals with the recognition and measurement of the impairment of fixed assets and the implications of this for future accounting periods. (7 marks)
- (b) AB, a public limited company, complies with FRS 11 as regards the impairment of its fixed assets. The following information is relevant to the impairment review.
- (i) Certain items of machinery appeared to have suffered a fall in value. The product produced by the machines was being sold below its cost and this occurrence had affected the value of the productive machinery. The carrying value at historical cost of these machines is £290,000 and their net realisable value was estimated at £120,000. The anticipated net cash inflows from the machines were £100,000 per annum for the next three years. A market discount rate of 10% per annum is to be used in any present value computations. (4 marks)
- (ii) AB acquired a car taxi business on 1 January 20X8 for £230,000. The values of the assets of the business at that date based on net realisable values were as follows.

	£'000
Vehicles	120
Intangible assets (taxi licence)	30
Debtors	10
Cash	50
Creditors	(20)
	<u>190</u>

On 1 February 20X8, the taxi company had three of its vehicles stolen. The net realisable value of these vehicles was £30,000 and because of non-disclosure of certain risks to the insurance company, the vehicles were uninsured. As a result of this event, AB wishes to recognise an impairment loss of £45,000 (inclusive of the loss of the stolen vehicles) due to the decline in the value in use of the income generating unit, that is the taxi business. On 1 March 20X8 a rival taxi company commenced business in the same area. It is anticipated that the business revenue will be reduced by 25% and that a further impairment loss has occurred due to a decline in the present value in use of the business which is calculated at £150,000. The NRV of the taxi licence has fallen to £25,000 as a result of the rival taxi operator. The net realisable values of the other assets have remained the same as at 1 January 20X8 throughout the period. (7 marks)

Required

Describe how AB should treat the above impairments of assets in its financial statements. (In part (b)(ii) candidates should show the treatment of the impairment loss at 1 February 20X8 and 1 March 20X8).

Please note that the mark allocation is shown after paragraph (b)(i) and (b)(ii) above.

(25 marks)

IMPAIRMENT

Tutor's hint. This question required you to discuss the impairment of assets in terms of the indicators of the impairment loss under FRS 11. The final part of the question required candidates to apply the principles of part (a) to two small cases.

Examiner's comment. Candidates performed very well on this question, particularly parts (a) and (b)(i). In part (b)(ii) some candidates did not realise that the carrying amount of the asset should not be reduced below net realisable value.

- (a) (i) Indications of an impairment loss include the following.
- (1) A significant decrease in the market value of an asset in excess of normal depreciation
 - (2) Adverse, significant changes in the value of the business or market in which the asset is used
 - (3) Technological, economic, legal or environmental changes affecting the business in which the asset is used
 - (4) Financial factors such as interest rate changes, market profitability, current period operating losses and net cash outflows adversely affecting the entity which uses the asset
 - (5) A major loss of key employees
 - (6) Damage, obsolescence or other physical changes to the asset
 - (7) An indication that construction or purchase costs have increased so that expected profits from new assets will not arise as originally expected
 - (8) Management commitment to reorganisation or redundancy programmes
 - (9) Adverse changes in the fair value indicators used to establish the fair value of an asset, eg multiples of turnover
- (ii) Under FRS 11 possible impairment losses are treated as follows.
- (1) If any of the above indicators suggest an impairment has occurred then an impairment review must be carried out.
 - (2) The carrying value of an asset is compared to its recoverable amount (the higher of NRV and value in use).
 - (3) For assets held at cost less depreciation if the carrying amount exceeds the recoverable amount, the asset is impaired and must be written down through the profit and loss account.
 - (4) Where assets are held at valuation impairment losses are recognised in the statement of total recognised gains and losses until the carrying value falls below depreciated historical cost. Impairments below depreciated historical cost are recognised in profit and loss account.
 - (5) It may be more convenient to test impairment for groups of assets known as 'income generating units' (IGU). Impairment should be tested for the smallest IGU which produces an independent income stream. Impairment losses in an IGU should be allocated firstly to goodwill, then capitalised intangibles and finally to tangible assets.
 - (6) Past impairment losses may be reversed if the recoverable amount increases because of changed economic conditions. The losses should only be reversed to the original carrying amount, i.e. the amount it would have been if the original impairment had not occurred.

(7) When impairment losses arise on fixed assets, the remaining useful economic life should be reviewed and revised if necessary.

- (b) (i) Impaired assets need to be written down to their recoverable amount, which is the higher of NRV and value in use.

For the productive assets:

Carrying value	£290,000
Value in use is 300,000 discounted at 10% for 3 years	£248,000
NRV	£120,000

The impairment loss is therefore $£(290,000 - 248,600) = £41,400$.

This will be written off to the profit and loss account.

- (ii) Impairment losses should be recognised if the recoverable amount of the income generating unit is less than the carrying value of the unit (the taxi business).

At February 1 20X8

	1.1.X8	Impairment loss	1.2.X8
	£'000	£'000	£'000
Goodwill (230 – 190)	40	(15)	25
Intangibles	30	-	30
Vehicles	120	(30)	90
Sundry net assets	<u>40</u>	<u>-</u>	<u>40</u>
	<u>230</u>	<u>(45)</u>	<u>185</u>

An impairment loss of £30,000 is recognised for the stolen vehicle the balance of £15,000 attributable to the IGU is applied initially to goodwill.

At 1 March 20X8

	1.2.X8	Impairment loss	1.3.X8
	£'000	£'000	£'000
Goodwill (230 – 190 – 15)	25	(25)	-
Intangibles	30	(5)	25
Vehicles	90	-	90
Sundry net assets	<u>40</u>	<u>-</u>	<u>40</u>
	<u>185</u>		<u>155</u>

In this case, there is an indication that the value of the intangible asset, the licence, has fallen to £25,000 so an impairment loss of £5,000 is recognised. There is no indication that the other tangible assets are impaired but value in use has fallen to £150,000.

NRV is therefore assumed to be $£185,000 - £25,000$ (goodwill) – $£5,000$ (licence) = $£155,000$.

The carrying amount is reduced to the higher of NRV or value in use as the recoverable amount.