

IMPAIRMENT OF ASSETS

FRS 11 *Impairment of fixed assets and goodwill* was published in July 1998. It deals with an important aspect of accounting for fixed assets for which there had previously been no guidance.

Required

- (a) According to FRS 11, when is an asset impaired and how is that impairment calculated? (4 marks)

- (b) FRS 11 recognises that it will not always be easy to tell when a fixed asset might be impaired. Briefly list the indicators of impairment noted in the standard. (4 marks)

- (c) Entity R has a single substantial asset, the ST, which it uses to manufacture UVs. The carrying value of the ST after 4 years (in 1999) is £5m (cost £7m, accumulated depreciation on a straight line basis of £2m). There is no expected residual value. Due to a breakthrough in technology in the manufacture of UVs, Entity R now expect the machine to produce 30% less in revenue terms than expected over the rest of its estimated useful life of 10 years. Net future cash flows for the next 5 years, based on management's best estimate after taking the 30% cut into account are (£'000):

Year	1	2	3	4	5
Future cash flows	600	660	710	755	790

The expected growth rates for the following years are:

Year	6	7	8	9	10
Rate of growth	2%	(1)%	(7)%	(16)%	(30)%

If the machine was sold now it would realise £3.2m, net of selling costs.

Calculate the recoverable amount of the ST and hence any impairment loss.

(10 marks)

- (d) FRS 11 introduced the term 'income generating unit'.

- (i) Define 'income generating unit'. (2 marks)

- (ii) Identify the income generating unit in the following cases.

- (1) A manufacturer can produce a product at a number of different sites. Not all the sites are used to full capacity and the manufacturer can choose how much to make at each site. However, there is not enough surplus capacity to enable any one site to be closed. The cash inflows generated by any one site therefore depend on the allocation of production across all sites.

- (2) A restaurant chain has a large number of restaurants across the country. The cash inflow of each restaurant can be individually monitored and sensible allocations of cost to each restaurant can be made. (5 marks)

(25 marks)

Note. PV factors at 10% are as follows.

Year	PV factor @10%
1	0.90909
2	0.82645
3	0.75131
4	0.68301
5	0.62092
6	0.56447
7	0.51316
8	0.46651
9	0.42410
10	0.38554

IMPAIRMENT OF ASSETS

(a) An asset is impaired when its carrying amount falls below its recoverable amount, where recoverable amount is the higher of the value in use of the asset or its net realisable value. This is the central rule of the standard.

(i) Carrying amount is the cost or revalued amount of the asset that is recognised in the balance sheet, less accumulated depreciation (or 'amortisation' for intangibles) and impairment losses to date.

(ii) Value in use is calculated by working out all the future cash flows expected to arise from both the asset's continued use and its eventual sale and then discounting all these to their present value.

(iii) Net realisable value is the estimated sales value of the asset now, less the costs of disposal, where the sale is between willing and knowledgeable parties (ie the sale is not forced, nor at an inflated value).

The impairment loss that must be recognised is therefore the difference between the carrying value and a lower recoverable amount.

(b) Examples of events and changes in circumstances that indicate an impairment may have occurred include the following.

(i) A current period operating loss in the business in which the fixed asset or goodwill is involved or net cash outflow from the operating activities of that business, combined with either past operating losses/net cash outflows or expected continuing operating losses/net cash outflows.

(ii) A significant decline in a fixed asset's market value during the period.

(iii) Evidence of obsolescence or physical damage to the fixed asset.

(iv) A significant adverse change in:

(1) either the business or the market in which the fixed asset or goodwill is involved, such as the entrance of a major competitor;

(2) the statutory or other regulatory environment in which the business operates; or

(3) any 'indicator of value' (for example turnover) used to measure the fair value of a fixed asset on acquisition.

(v) A commitment by management to undertake a significant reorganisation.

(vi) A major loss of key employees.

(vii) A significant increase in market interest rates or other market rates of return that are likely to affect materially the fixed asset's recoverable amount.

- (c) The net selling price of the machine is below its carrying value so it is definitely impaired. It is now necessary to find value in use in order to determine what the impairment loss is.

Year	Long term growth rate	Projected future cash flows £'000	PV factor at 10%	Discounted future cash flows £'000
1		600	0.90909	545
2		660	0.82645	545
3		710	0.75131	533
4		755	0.68301	516
5		790	0.62092	491
6	+3%	806	0.56447	455
7	-1%	798	0.51316	409
8	-7%	742	0.46651	346
9	-16%	623	0.42410	264
10	-30%	436	0.38554	168
Total				<u>4,272</u>

To calculate the impairment loss, compare the carrying value of £5m with the higher of value in use (£4.272m) and net selling cost (£3.2m). The impairment loss is therefore £5m - £4.272m = £728,000.

- (d) (i) To determine whether impairment of a fixed asset has occurred, it is necessary to compare the carrying amount of the net asset with its recoverable amount. The recoverable amount is the higher of net realisable value and value in use. It is not always easy to estimate value in use. In particular, it is not always practicable to identify cash flows arising from an individual fixed asset. If this is the case, value in use should be calculated as the level of income generating units.

An income generating unit is defined as a group of assets, liabilities and associated goodwill that generates income that is largely independent of the reporting entity's other income streams. The assets and liabilities include those already involved in generating the income and an appropriate portion of those used to generate more than one income stream.

- (ii) (1) The income-generating unit comprises all the sites at which the product can be made.
- (2) Each restaurant is an income-generating unit by itself. However, any impairment of individual restaurants is unlikely to be material. A material impairment is likely to occur only when a number of restaurants are affected together by the same economic factors. It may therefore be acceptable to consider groupings of restaurants affected by the same economic factors rather than each individual restaurant.