NAS 36 Impairment of Assets : Introduction

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Summary

This documents is just a introduction to basic concepts of impairment of assets. This document is background material for discussion to be held at coming Friday class of J Santosh & Co.

Reference:

IAS 36 http://www.iasplus.com/standard/ias36.htm

NAS 18 [www.ican.org.np/_downloads/accstd/**NAS18**.pdf](www.ican.org.np/_downloads/accstd/NAS18.pdf)

IFRS Financial Reporting Manual 2007

IFRS Pocket 2011
http://www.iasplus.com/dttpubs/pocket2011.pdf

Contents

IAS 36 / NAS 18 Impairment of assets

Meaning :

Impairment of asset is weakening in value of asset. In other words, when the value of asset decreases we may call it impairment of an asset. As per NAS 18 asset is said to be impaired if carrying amount of an asset or a cash generating unit exceeds its recoverable amount.

Presentation:

Assets:	
Plant at cost	100
Less: Accumulated depreciation	20
Less: Impairment loss	10
	70

1. An asset shall not be recorded in excess of its **recoverable amount**.

of an asset or a cash-generating unit is the higher of

its fair value less costs to sell &

Amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Sources & basis of fair value less costs to sell can be from

1. Binding sale agreement
2. Active Market
3. Best estimate based on information

its value in use

Present value of the future cash flows expected to be derived from an asset or cash generating unit.

Present value is calculated by applying discount rate to future cash flows

Para 34 How future cash flows is determined ?

Future cash flows should be based on

(a) reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset.

(b) the most recent financial budgets/forecasts approved by management, but shall exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance.

(c) cash flow projections beyond the period covered by the most recent budgets/forecasts shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified.

Para 40 Composition of estimated cash flows

Estimates of future cash flows shall include:

(a) projections of cash inflows from the continuing use of the asset;

(b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and

(c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

Para 51. Estimates of future cash flows shall not include:

(a) cash inflows or outflows from financing activities; or

(b) income tax receipts or payments.

Para 56. Discount rate

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.

Para 2 Applicability

This Standard shall be applied in accounting for the impairment of all assets, other than:

(a) inventories (NAS 04);

(b) assets arising from construction contracts (NAS 13);

(c) deferred tax assets (NAS 09);

(d) assets arising from employee benefits (NAS 14);

(e) financial assets;

(f) investment property that is measured at fair value;

(g) biological assets related to agricultural activity that are measured at fair value less estimated point-of-sale costs;

(h) deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts; and

(i) non-current assets (or disposal groups) classified as held for sale.

How do we know that the asset has impaired : Para 10 Impairment Test

An entity shall assess at each reporting date whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset.

13. In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

External sources of information

(a) asset's market value has declined

(b) adverse effect on the entity due to change in technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.

(c) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

(d) the carrying amount of the net assets of the entity is more than its market capitalisation.

Internal sources of information

(e) obsolescence or physical damage of an asset.

(f) adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used.

(g) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

Above indications are only illustrative and not to be taken as exhaustive or conclusive.

Effect of impairment on depreciation / amortization Para 18

If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation (amortization) method or the residual value for the asset needs to be reviewed and adjusted in accordance with the Standard applicable to the asset, even if no impairment loss is recognized for the asset.

Para 64

After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

Recognition & Measurement of Impairment Loss

Recoverable Amount > Carrying amount = Difference (if any)

= Impairment Loss

Recognized immediately in profit or loss

unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in PARA 06 Property, Plant and Equipment). Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.

PARA 63

When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognize a liability if, and only if, that is required by another Standard.

Amount of impairment loss will differ if asset is carried at historical cost and if carried at revalued price.

	If asset is carried at historical cost	**If asset is carried at revalued amount**
Impairment loss	Carrying amount of an asset (Historical cost less depreciation) – Recoverable amount	Carrying amount of asset (Revalued price less depreciation) – Recoverable amount
Recognition	Profit & Loss A/C as expense	Impairment loss equal to Revaluation reserve (surplus) shall be set off against **Revaluation Surplus** Impairment loss in excess of revaluation surplus balance shall be recognised as an expense in Profit & Loss A/c.

Recoverable amount of individual asset cannot be determined

108. If the recoverable amount of an individual asset cannot be determined (see paragraph 68):
(b) no impairment loss is recognised for the asset if the related cash-generating unit is not impaired. This applies even if the asset's fair value less costs to sell is less than its carrying amount.

Impairment Loss and deferred tax

If an impairment loss is recognised, any related deferred tax assets or liabilities are determined in accordance with NAS 09 *Income Taxes* by comparing the revised carrying amount of the asset with its tax base

Reversing an impairment loss

111. An entity shall assess at each reporting date whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset.

112. In assessing whether there is any indication that an impairment loss recognized in prior periods for an asset other than goodwill may no longer exist or may have decreased, an entity shall consider, as a minimum, the following indications:

External sources of information	Internal sources of information
(a) the asset's market value has increased significantly (b) significant favourable effect on the entity due to technological, market, economic or legal environment in which the entity operates or in the market to which the asset is dedicated. (c) market interest rates or other market rates of return on investments have decreased	(d) significant favourable changes in method of use of the asset. These changes include costs incurred during the period to improve or enhance the asset's performance or restructure the operation to which the asset belongs. (e) evidence that economic performance of the asset is, or will be, better than expected.

PARA 115. Reversing an impairment loss

An impairment loss recognized in prior periods for **an asset other than goodwill** shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized.

If this is the case, the carrying amount of the asset shall, except as described in paragraph 118, be increased to its recoverable amount.
That increase is a reversal of an impairment loss.

PARA 118. Reversing an impairment loss for an individual asset

The increased carrying amount of an asset other than goodwill attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of amortization or depreciation) had no impairment loss been recognized for the asset in prior years.

PARA 120
A reversal of an impairment loss for an asset other than goodwill

immediately in profit or loss,

unless the asset is carried at revalued amount in accordance with another Standard (for example, the revaluation model in NAS 06 Property, Plant and Equipment). Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with that other Standard.

Asset A/c Dr.
To Reversal of Impairment

Reversal of impairment Dr.
To Profit & Loss a/c

A reversal of an impairment loss on a revalued asset is credited directly to equity under the heading revaluation surplus. However, to the extent that an impairment loss on the same revalued asset was previously recognised in profit or loss, a reversal of that impairment loss is also recognised in profit or loss.

PARA 122
After a reversal of an impairment loss is recognized, the depreciation (amortization) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

Reversing an impairment loss for a cash-generating unit
123. A reversal of an impairment loss for a cash-generating unit shall be allocated to the assets of the unit, except for goodwill, pro rata with the carrying amounts of those assets. These increases in carrying amounts shall be treated as reversals of impairment losses for individual assets and recognised in accordance with paragraph 120.

124. In allocating a reversal of an impairment loss for a cash-generating unit in accordance with paragraph 123, the carrying amount of an asset shall not be increased above the lower of:
(a) its recoverable amount (if determinable); and
(b) the carrying amount that would have been determined (net of amortization or depreciation) had no impairment loss been recognised for the asset in prior periods.
The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset shall be allocated pro rata to the other assets of the unit, except for goodwill.

Reversing an impairment loss for goodwill Para 125
An impairment loss recognized for goodwill shall not be reversed in a subsequent period.

Cash Generating Unit

The CGU is the smallest identifiable group of assets

- that generates cash inflows from continuing use, and
- that are largely independent of the cash inflows from other assets or groups of assets.

Sometimes aggregation of CGUs become necessary if each of the CGUs cannot be DISPOSED off separately even if cash flows from each CGU can be determined independently.

PARA 67 : Cash Generating Unit [CGU]

If there is any indication that an asset may be impaired

↓

Recoverable amount shall be estimated for the individual asset

↓ If this is not possible

Determine the recoverable amount for the cash-generating unit (CGU) to which that asset belongs.

Identification of an asset's cash-generating unit involves judgement. If recoverable amount cannot be determined for an individual asset, an entity identifies the lowest aggregation of assets that generate largely independent cash inflows.

Example 1 :
A mining entity owns a private railway to support its mining activities. The railway is used to transport the ore mined and does not generate revenue the way passenger trains do. The private railway could be sold only for scrap value and it does not generate cash inflows that are largely independent of the cash inflows from the other assets of the mine.
It is not possible to estimate the recoverable amount of just the private railway by itself because its value in use cannot be determined and is probably different from scrap value. Therefore, the entity estimates the recoverable amount of the cash-generating unit to which the private railway belongs, i.e. the mine as a whole.

Example 2
A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss. Because the entity does not have the option to curtail any one bus route (it MUST operate all 5), the lowest level of identifiable cash inflows that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the 5 routes together. The cash-generating unit for each route is the bus company as a whole.

PARA 73

Cash-generating units shall be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

PARA 76.

The carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount of the cash-generating unit is determined.

Disclosures Para 127, 130, 131, 132

Disclosures can be categorised into 4 major categories:

Basic requirements for each class of assets	An entity shall disclose the following for each class of assets: (a) the amount of impairment losses recognised in profit or loss during the period and the line item(s) of the income statement in which those impairment losses are included. (b) the amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) of the income statement in which those impairment losses are reversed. (c) the amount of impairment losses on revalued assets recognised directly in equity during the period. (d) the amount of reversals of impairment losses on revalued assets recognized directly in equity during the period.
Requirements for segment reporting	An entity that reports segment information shall disclose the following for each reportable segment based on an entity's primary reporting format: (a) the amount of impairment losses recognised in profit or loss and directly in equity during the period. (b) the amount of reversals of impairment losses recognised in profit or loss and directly in equity during the period.
Requirement for cash generating unit	An entity shall disclose the following for each material impairment loss recognised or reversed during the period for an individual asset, including goodwill, or a cash-generating unit: (a) the events and circumstances that led to the recognition or reversal of the impairment loss. (b) the amount of the impairment loss recognised or reversed. <u>(c) for an individual asset:</u> (i) the nature of the asset; and (ii) if the entity reports segment information, the reportable segment to which the asset belongs, based on the entity's primary reporting format.

	<u>(d) for a cash-generating unit:</u> (i) a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, or a reportable segment); (ii) the amount of the impairment loss recognised or reversed by class of assets and, if the entity reports segment information, by reportable segment based on the entity's primary reporting format; and (iii) if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), a description of the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified. (e) Whether the recoverable amount of the asset (cash-generating unit) is its fair value less costs to sell or its value in use. (f) if recoverable amount is fair value less costs to sell, the basis used to determine fair value less costs to sell (such as whether fair value was determined by reference to an active market). (g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.
Requirement for reversal of impairment loss	An entity shall disclose the following information for the aggregate impairment losses and the aggregate reversals of impairment losses recognised during the period for which no information is disclosed in accordance with paragraph 131: (a) the main classes of assets affected by impairment losses and the main classes of assets affected by reversals of impairment losses. (b) the main events and circumstances that led to the recognition of these impairment losses and reversals of impairment losses.

Para 134.
If, in accordance with paragraph 85, any portion of the goodwill acquired in a business combination during the period has not been allocated to a cash generating unit (group of units) at the reporting date, the amount of the unallocated goodwill shall be disclosed together with the reasons why that amount remains unallocated.

Effects of Impairment

Effects of Impairment		
Financial Statements	**With Impairment Loss**	**Without impairment loss**
Balance sheet	Lower. The carrying amount (net book value) of the asset is reduced as a result of the write-down or impairment loss.	Higher. No asset adjustment is made on the financial statement.
Equity	Lower. Impairment loss causes a reduction in net income; this amount flows through the equity account as a reduction.	Higher. There is no reduction of net income.
Income	Lower. The impairment loss is an immediate expense.	Higher. No impairment loss is recorded.
Total assets turnover	Higher. Total asset is reduced.	Lower. There is no reduction in asset.
Debt ratio	Higher. Because of asset reduction, total assets are decreased.	Lower. There is no reduction in asset.
Profit margin	Lower. The impairment loss would decrease the net income.	Higher. There is no effect on the net income.

Key Question

In the dynamic marketplace, the fair value of an asset changes over time because of technological advances, obsolescence, and ferocious competition, all of which affect pricing. As a result, are the assets reasonably tested for impairment?

Analyst's Role

The analyst should:

- Recognize impairment loss. Impairment significantly influences financial statements. If impairment loss is not recognized, the value of the company is overstated.
- Make sure that goodwill and other intangible assets with indefinite useful lives are tested for impairment at least annually, even though they are not subject to amortization.
- Be cognizant of indicators that cause impairment loss, such as a significant change in the usage of the asset; a significant adverse change in the legal environment or in the business climate that affects the fair value of the asset; and a projection that indicates a constant loss with an asset.

Questions

1. An asset does not meet environment laws, which have been recently enacted. The asset has to be destroyed as per the laws. The asset is carried in the balance sheet at the year end at Rs. 60,000. Estimated cost of destroying it is Rs. 70,000. How is it to be accounted?
2. Reliance Industries Ltd. Is a multi-product manufacturing company, its corporate office is house in a building, as the area of building is large, the Reliance Industries Ltd. Has let out ½ area of building at a monthly rent of Rs. 50 lakhs, the lease agreement with tenant is for next 5 years. Is the building cash generating unit? If not what is cash generating unit of building?
3. Deep Industries Ltd. purchased a machine on 1.1.2009 for Rs. 50 lakhs having a useful life of 5 years. On 31.12.2010 its carrying amount is Rs. 30 lakhs. Due to fire, in a factory, there is some damage to machinery but it is still working, its fair value less costs to sell on 31.12.2010 is Rs. 22 lakhs. M/C does not generate independent cash flows from use. The smallest group of asset that includes this machine generates cash flows largely independent of other assets, the carrying amount of group of assets to which this machine belongs is Rs 200 lakhs and the recoverable amount of group of assets (Cash generating unit) to which the machine belongs is Rs. 220 lakhs. Calculate impairment loss for the machine.