APPLICATION REVIEW OF IAS 36: THE ISSUES COMPANIES FACE REGARDING IMPAIRMENT OF ASSETS

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Abstract
This article is mainly based on IAS 36 Impairment of Assets with focus on the impairment of property, plant and equipment, intangible assets and goodwill. Taking into consideration all the peculiarities usually occurred during the process of impairment, it is important to understand whether the impairment test is required and how to measure and allocate the impairment loss if this is the case. This article will cover main indicators of impairment within the scope of IAS 36, determination of Cash Generating Units (CGUs) and also recognition of the impairment loss and its allocation to the CGUs.

Key words: *impairment, IAS 36, assets, intangibles, goodwill, cash-generating unit, indicators of impairment, recoverable amount, value in use, fair value less costs of disposal, allocation, reversal, disclosure*

1. INTRODUCTION

Impairment represents an essential part of the strategy for transition from historical to fair value accounting principles.

When the prudence concept is no longer the major issue and is replaced by the fair value, which is determined on the basis of the pricing model rather than current market prices, a monitoring mechanism is needed for preventing overly optimistic evaluations.

IAS 36 sets out the procedures that an entity must apply to ensure that its assets are carried at no more than the amount expected to be recovered through use or sale of these assets.

Although the key regulations of Standard are quite precise, the application of it has always been changeling and many problems have been brought into the focus during the recent economic uncertainty.

2. TESTING FOR IMPAIRMENT

In IAS 36 there is an important difference between determining the presence of impairment indicators and actual impairment test performance. Standard contains two general requirements with respect to the procedure of performing the impairment test

- Intangible assets with indefinite life and goodwill must be tested for impairment at least annually and at the same time every year
- For other assets in the scope of IAS 36 entity should determine the presence of indicators of impairment at each reporting date. The impairment test is only performed in case of existence of those indicators was proved.

Besides, book value of the intangible asset that is still unavailable for use should be tested at least annually. This arises from the fact that a great uncertainty related to intangibles exists up to the point of time they are brought into operation.

IAS 36 presents some examples of impairment indicators. The list of indicators provided by Standard is a minimum that entities should consider and is not exhaustive. All indicators are divided into internal and external ones.

External sources of information:

- decline of market value of asset
- negative changes in technology, markets, economy, or laws
- increases in market interest rates
- company's book value exceeds its stock price

Internal sources of information:

- obsolescence or physical damage
- asset is part of a restructuring or held for disposal
- worse economic performance of the asset than expected

However, in accordance with IAS 36 the presence of impairment indicators does not necessarily result in calculation of the recoverable amount. It may be possible that in prior period large headroom[1] occurred and it is unlikely to be eroded by any event. Likewise it could have been determined that an asset (or goodwill) is not sensitive to those particular indicators.

There are two elements of a great importance stated in the list. The first one is the market capitalisation. If market capitalisation shows a lower figure than the book value of net assets, it suggests the market considers that the business is overvalued.

It doesn't necessarily concern the return that entity generates on its assets. Many factors could have been brought into estimation of market value, for example, high level of debts that company is unable to cover, financial crises and etc. This way market capitalisation below the book value is not always followed by an impairment loss. However, in most cases entity eventually has to test goodwill and CGU for impairment in accordance with IAS 36. Entity needs to understand reasons for shortfall in the first place.

Second important element observed through list of indicators is the performance of economic asset. Thus, IAS 36 requires an impairment test for those assets which present or future level of performance is significantly below the target. This can result in necessity of impairment test either for only this particular asset or the CGU to which this asset is allocated and even the whole company.

3. VALUATION ISSUES

The Standard requires comparison of the book value and the recoverable amount. The recoverable amount is the highest of value in use (VIU) and fair value less costs of disposal (FVLCD).

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit. Fair value less costs of disposal is the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less costs of disposal. It is not always necessary to identify both VIU and FVLCD, because if one of them is already higher than the carrying amount then the asset is not impaired.

Standard describes a number of situations in which it can be more reasonable to use a FVLCD rather than VIU in determining the recoverable amount.

[1] The amount by which the recoverable amount exceeds its carrying amount

The evaluation on the basis of FVLCD is detailed in Standard. The best evidence of an asset's fair value less costs to sell is a price in a binding sale agreement in an arm's length transaction, adjusted for incremental costs that would be directly attributable to the disposal of the asset.

If there is no binding sale agreement but an asset is traded in an active market, fair value less costs to sell is the asset's market price less the costs of disposal.

If there is no binding sale agreement or active market for an asset, fair value less costs to sell is based on the best information available to reflect the amount that an entity could obtain, at the reporting date, from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal. [1]

All possible costs of disposal should be included in the FVLCD invariably. In accordance with IAS 36 and IAS 16, reorganization and employee benefit costs cannot be recognized as costs of disposal. If the disposal of an asset precedes the buyer to accept a liability, this liability should be deducted from FVLCD, when estimating the recoverable amount.

IAS 36 acknowledges that there may be circumstances in which it is not possible to obtain reliable evidence regarding the assumptions and techniques that market participants would use, so it would be difficult to conclude that FVLCS could be estimated with sufficient reliability for impairment testing purposes. In such a situation, the recoverable amount of the asset or CGU will be based on its VIU. [2]

IAS 36 requires to following elements to be reflected in the calculation of value in use [1]:

- an estimate of the future cash flows the entity expects to derive from the asset in an arm's length transaction;
- expectations about possible variations in the amount or timing of those future cash flows;
- the time value of money, represented by the current market risk-free rate of interest;
- the price for bearing the uncertainty inherent in the asset; and
- other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

In measuring value in use an entity shall [1]:

- base cash flow projections on 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.
  - *Greater weight shall be given to external evidence.*
- base cash flow projections on 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.
  - *Projections based on these budgets/forecasts shall cover a maximum period of five years, unless a longer period can be justified.*
- estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified.
  - *This growth rate 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.*

Estimates of future cash flows shall include:

- projections of cash inflows from the continuing use of the asset;

- projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and
- net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

Cash flow projections should relate to the asset in its current condition – future restructurings to which the entity is not committed and expenditures to improve or enhance the asset's performance should not be included in estimates of future cash flows. Estimates of future cash flows shall not include cash inflows/outflows from financial activities or any income tax receipts or payments.

The discount rate shall be a pre-tax rate that reflects current market assessments of the time value of money and also the risks specific to the asset for which the future cash flow estimates have not been adjusted.

Because of the issues in calculating an appropriate pre-tax discount rate and because it aligns more closely with their normal business valuation approach, some entities attempt to perform a VIU calculation based on a post-tax rate and post-tax cash flows. It is possible for a post-tax approach to give the same answer as a pre-tax approach. Indeed, IAS 36's Basis for Conclusions states that, in theory, discounting post-tax cash flows at a post-tax discount rate and discounting pre-tax cash flows at a pre-tax discount rate should give the same result, provided the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax flows. [3]

After identification of the recoverable amount of the asset, it should be compared with the book value of this asset and in case the asset's RA exceeds its BV the impairment loss should be recognized immediately in accordance with IAS 36.

4. RECOGNITION AND MEASUREMENT OF IMPAIRMENT LOSS

If the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss.

However, it is not always possible to estimate the recoverable amount of the individual asset, then an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs.

The recoverable amount of an individual asset cannot be determined if [1]:

- the asset's value in use cannot be estimated to be close to its fair value less costs to sell (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and
- the asset does not generate cash inflows that are largely independent of those from other assets.

When determining the CGU, it should be done at the lowest level, on which the independent cash inflows are generated. Besides, "independent cash inflows" does not necessarily mean that those inflows were generated externally.

In practice, various entities apply various determination approached that makes the process of identifying of CGU highly subject to judgment. Therefore, it requires a very good knowledge of the industry and of the organization of the company.

Example 1

An entity has a chain of stores, relying primarily on "walk-in" customers, are located in the same country. The business model of the entity is highly integrated such that the majority of the entity's revenue generating decisions is carried out at an entity level by the executive committee with some decisions delegated to the store or regional levels.

The majority of the operations, such as purchasing, are centralised. The benefit of the entity's centralised structure results in higher sales volumes in all of its outlets as compared to the industry average, which will be factored into the cash flow projections. Past history verifies that only in rare situations the entity has sold an individual outlet.

Some decisions within the entity are made at a regional level due to the similarity of customer offers within a region. Such offers are made only when there is a net benefit to the region irrespective of the individual outlet benefit / loss. Individual outlets promote other outlets and share staff.

Management operates its business on a regional basis. This is evidenced by the management reporting structure.

Determination of CGU

The CGU is determined at the lowest level possible. In other words, it is necessary to identify at which level the independent cash inflows are generated. Examples of factors that should be considered are listed below:

1. *To what extent will the revenue of the whole group of stores change if something happens to a single outlet?*
2. *At which level (single store or group) is the client base formed?*
3. *On which bases are the outlets monitored?*

Table 1. Factors for determination of CGU

Factors	***Single store is a CGU***	***The chain is a CGU***
If one of the outlets is discontinued is it likely that the profit of the chain will fall?	*The closure of an outlet causes a decrease in the cash inflows, indicating that its cash inflows are independent of the other outlets.*	*The closure of an outlet does not affect the revenue because other outlets absorb the customer base of the closed outlet.*
Does each outlet have its own client base?	*Each outlet has its own customer base through contract or other loyalty that are unrelated to other stores.*	*Customers are not attached to any specific outlet and are freely able to change outlets for their purchases.*
Whether the outlets are monitored on an individual or a regional basis?	*Management monitors the cash inflows and performance of each store individually and makes decisions on that basis.*	*Management monitors cash inflows and performance of the chain of stores (as a whole or within region).*

Source: Own compilation

No single factor is, of itself, determinative of whether an individual outlet is a CGU or not. All factors should be considered as to the ability of the store to independently generate cash inflows.

In this particular case, although the entity uses centralized business model, it does not influence a single store's capacity to generate independent cash inflows.

Regardless of the fact that the management monitors the stores at a regional level, there is no other evidence that will allow changing the CGU from the single outlet. Therefore, an individual store is a CGU in this case.

However, if the circumstances are slightly being changed, for example, a number of outlets have the same customer base due to close set of stores or the outlets serve as distribution centers, then cash inflows will be generated by the chain independent of the single store's profit.

Another important category in determination of CGU is the presence of an active market. Thus, if a company, for instance, sells the surpluses of the intermediate product and its sale is a genuine incidental activity, this market should not be regarded as an active market for the purposes of applying IAS 36.

Allocation of goodwill and corporate assets to CGU

Goodwill. For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination. [1]

Goodwill recognised in a business combination represents the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

Goodwill cannot generate independent cash flows, and often contributes to the cash flows of multiple cash-generating units.

It shall be allocated to level of each of the CGUs, if non-arbitrary allocation is possible. However, sometimes goodwill cannot be allocated to individual CGU, but only to a group of CGUs. In this case, there are two condition to be met for such a group:

- It should represent the lowest level within the entity at which the goodwill is monitored for internal management purposes, and
- It should not be larger than an operating segment (as defined in IFRS 8)

A CGU to which goodwill has been allocated shall be tested for impairment annually, irrespective of whether there is an indication that the unit may be impaired. If goodwill related to a cash-generated unit, but still is not allocated to that unit, then this unit should be tested for impairment by comparing its book value, excluding goodwill, with its recoverable amount.

It might also not be possible to complete the initial allocation of the goodwill recognised in the business combination before the end of the reporting period. When this is the case, in accordance with IAS 36.133, the amount of the unallocated goodwill shall be disclosed together with the reasons why it remains unallocated.

Corporate assets. Corporate assets include group or divisional assets such as the building of a headquarters or a division of the entity, EDP equipment or a research centre. [1]

Since corporate assets do not generate independent cash inflows, the recoverable amount of an individual corporate asset cannot be determined unless it is decided to dispose of the asset. As a consequence, if there are indicators of impairment, recoverable amount is determined for the CGU or group of CGUs to which the corporate asset belongs, and is compared with its carrying amount.

In accordance with IAS 36.102, if a portion of the carrying amount of a corporate asset cannot be allocated on a reasonable and consistent basis to the CGU, the entity shall:

1. compare the carrying amount of the unit, excluding the corporate asset, with its recoverable amount and recognize any impairment loss;
2. identify the smallest group of CGUs that includes the CGU under review and to which the carrying amount of the corporate asset can be allocated;
3. compare the carrying amount of that group of CGU, including the carrying amount of the corporate asset allocated to that group of units, with the recoverable amount of the group of units.

Reorganisation and disposal. There are various reasons why entities might reorganise their businesses:

- growth
- contraction

- acquisitions
- disposals
- efficiency moves
- technological change and etc.

An entity may reorganise its reporting structure in a manner that changes the composition of the CGUs to which goodwill has been allocated or dispose of an operation within a CGU (group of CGUs). In both cases the similar approach is used to reallocate goodwill. IAS 36 requires goodwill to be reallocated to the units affected using a relative value approach, unless the entity can demonstrate that some other method better

- If a CGU (group of CGUs) is being reallocated to other CGUs (group of CGUs) as part of a reorganisation, then its goodwill must be reallocated based on the relative value of those parts that are to be integrated
- For a disposal, goodwill is allocated between the operation disposed of (thereby affecting the gain or loss on disposal) and the portion of the CGU retained, based on their relative values

In both cases, the relative value approach is used unless the entity can demonstrate that some other method better reflects the goodwill associated with the reallocated operations or operations disposed of. [2]

4.3. Impairment loss for a cash-generating unit.

The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:

- first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
- then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units). [1]

In allocating an impairment loss, an entity shall not reduce the carrying amount of an asset below the highest of:

- its fair value less costs to sell (if determinable);
- its value in use (if determinable); and
- zero.

The amount 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 (group of units). [1]

Example 2

A parent company B, has identified a cash generating unit C. The net assets of C are as follows.

Table 2. Net assets of company C

Assets	***CU***
Cash	*200*
Accounts receivable	*1 800*
Inventory	*1 400*
Goodwill	*1 500*

Patent	*1 900*
Factory	*11 600*
Plant and machinery	*5 700*
Delivery vehicles	*1 700*
Liabilities	
Bank loans	*(11 000)*
Accounts payable	*(3 000)*
Net Assets	*11 800*

Source: Own compilation

C is the smallest cash-generating unit and value in use of this CGU cannot be determined without including the bank loans and accounts payables. Accordingly, cash flow forecasts are prepared:

(a) From the most recent financial budgets/forecasts for the next 5 years; and

(b) By estimating subsequent cash flows based on declining growth rates.

These are discounted at a 12 percent discount rate, representing a pre-tax rate. This produces a figure for the value in use of the business of 6,000.

Due to a serious decline in demand for C's products, B concluded that it is necessary to perform an impairment test under IAS 36.

In the process of the FVLCD of C's assets determination the following was established:

1. The factory could be sold for 12,000.

2. The plant and machinery is highly specialized and would have no value other than as scrap, assessed at 100.

3. The delivery vehicles could be sold for 1,200.

4. The patent could be valued at 800, based on the relief from royalty approach.

The fair value less costs of disposal of C as a whole is not determinable, as it is unlikely that there would be a buyer for it.

First of all, it is necessary to assess whether fair value less costs of disposal or value in use is the proper measure of recoverable amount. The business is about to broke up, therefore goodwill will have no value.

Table 3. Calculation of fair value less costs of disposal

Assets	**CU**
Cash	200
Accounts receivable	1 800
Inventory	1 400
Goodwill	-
Patent	1 200

Factory	13 000
Plant and machinery	500
Delivery vehicles	1 200
Liabilities	
Bank loans	(11 000)
Accounts payable	(3 000)
Net Assets	5 300

Source: own calculations

Obviously, fair value less costs of disposal is lower than value in use; hence the value in use should be used as a recoverable amount of the CGU.

Comparing this with the carrying amount of the consolidated net assets and an impairment loss of 5,800 is identified. This is recognised immediately in the income statement.

Then the impairment loss should be allocated to assets of the CGU appropriately. The book value of goodwill should be eliminated first (in accordance with IAS 36). The remaining loss of 3 800 should be allocated to the other assets on a pro rata basis. However, the write down should not reduce any asset below its fair value less costs of disposal.

Table 4. Allocation of impairment loss

	Before write down	%, (1)	Write down (1)	Max	%, (2)	Reallocation (2)	Write down (1) + (2)	After write down
Plant and machinery	5,700	60,00	2,280	5200	73,08	132	2.412	3.288
Delivery vehicles	1,700	17,89	680	**500**	-	-	500	1.200
Patent	2,100	22,11	840	900	26,92	48	888	1.212
Total	9,500		3,800		5,700 + 2,100 = 7,800	180	3.800	5.700

Source: own calculations

Third column illustrates the pro-rata basis for allocation. Write down (1) shows the initial allocation of impairment loss, however, the amount of vehicles which can be written down is restricted by its FVLCD, and the maximum amount for write down in this case is 1.700 – 1.200 = 500. The amount of 680 – 500 = 180 should be allocated to remaining assets on the pro rata basis (6^{th} and 7^{th} columns). The final write down represents the sum of initial write down of plant and machinery and patent and reallocated to them loss from vehicles, and also vehicles carried at the lowest amount possible (1.200). The last column presents the value of impaired assets.

In practice, deferred tax effects would also be accounted for, in accordance with IAS 12 *Income Taxes.*

4.4. Reversing an impairment loss

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.

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 recognised for the asset in prior years.

An impairment loss recognised for goodwill shall not be reversed in a subsequent period. [1]

Only a part of allocated impairment loss can be reversed. For assets (other than goodwill) in the scope of IAS 36 the reversal cannot bring the carrying value to the amount which would be higher than the net book value of that asset considering amortization of the period in which the reversal was made.

Example 2 (continued)

Supplementary conditions:

In the following year, the fortunes of C improve because it discovers a new effective way of improving the technical performance of its product through the use of its patent and this allows it to increase both its sales and its margins.

As a result, its forecasted cash flows have improved and, when discounted, they now give rise to a revised value in use of 11,000.

IAS 36 requires an annual reassessment of previous impairment losses, and their reversal, subject to certain conditions, if they are no longer found to be necessary. In this case, there is an apparent need for a reversal of 5,000 currency units.

This is first applied to assets other than goodwill, on a pro rata basis, but not so as to increase the value of any asset above the carrying amount it would now be stated at if the original impairment write-down had not been made. This means that depreciation that would have been charged on the old carrying amount, in the meantime must be taken into account.

In this case this allows the plant and machinery, the patent and the delivery vehicles to be written back up to their previous carrying amount less a charge for depreciation for the current year.

After reversing the impairment loss on these assets to the extent permitted, the remaining amount of the 5,000 currency units' reversal cannot be applied in relation to goodwill.

Of the 5,000 currency units' increase in value in use, therefore, the only amount that may be recognised is the 3,800 currency units that related to the write down of assets other than goodwill, less the amount of one year's depreciation on these assets.

5. DISCLOSURE

Information to be disclosed can be divided into two large categories:

- Information concerning actual impairment losses or reversals of impairment for the period, which should be disclosed in case of value adjustment took place, regardless of class of the asset
- Information which should be disclosed annually concerning obligatory annual impairment test for goodwill and intangible assets with indefinite life, irrespective of whether the value adjustment were made or not.

An entity shall disclose the following for each class of assets [1]:

(a) the amount of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of comprehensive income 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 statement of comprehensive income in which those impairment losses are reversed.

(c) the amount of impairment losses on revalued assets recognised in other comprehensive income during the period.

(d) the amount of reversals of impairment losses on revalued assets recognised in other comprehensive income during the period.

In accordance with IAS 36.133, if 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 end of the reporting period, the amount of the unallocated goodwill shall be disclosed together with the reasons why that amount remains unallocated.

If a 'reasonably possible change' in a key assumption would cause a CGU's carrying amount to exceed its recoverable amount, the entity must disclose:

- The amount of headroom
- The value assigned to each key assumption
- The amount by which that value must change in order for the CGU's recoverable amount to be equal to its carrying amount

One problem that may be faced when reporting sensitivities is that assumptions may work in combination with one another. IAS 36 requires that consequential effects on all variables be reflected in the impairment test. For example, if a lower inflation rate is assumed, the discount rate may be lower as well. [2]

6. CONCLUSION

The role of impairment in system of International Financial Reporting Standards has strengthened mainly due to the adoption of following changes. First of all, the IFRSs do not imply amortization of goodwill anymore, thus all the entities recording goodwill in their consolidated financial statements should perform impairment test at least annually. Secondly, the Board of IFRS is expanding the use of fair value on the basis of pricing model rather that market transactions.

Despite the key role of the IFRS 36 in practice, it is still rather complicated for use. Most of the information required for valuation is not readily available (for example, discount rate) and the Standard is not always precise about the methods of valuation.

As a consequence, the principle of comparability, which is one of the key principles in IFRS, is harder to track in practice since the requirements of the Standard are interpreted by different companies in different ways.

These questions cannot be solved immediately without any clear theoretical footing. Therefore, it is important for companies to be introduced to a Standard providing unified methodology of impairment testing that will give single valued and comparable results.

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