



# INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF KENYA

## IMPAIRMENT OF ASSETS

Credibility

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AccountAbility

# IAS 36 OVERVIEW



- Objective and scope
- Identifying an asset that might be impaired
- Recognizing and measuring an impairment loss for an individual asset
- Recognizing and measuring an impairment loss for cash-generating units and goodwill
- Reversing an impairment loss
- Disclosure

# IAS 36- KEY DEFINITIONS



- **Impairment loss:** the amount by which the carrying amount of an asset or cash-generating unit exceeds its recoverable amount
- **Carrying amount:** the amount at which an asset is recognised in the balance sheet after deducting accumulated depreciation and accumulated impairment losses
- **Recoverable amount:** the higher of an asset's fair value less costs of disposal\* (sometimes called net selling price) and its value in use
- \* Prior to consequential amendments made by [IFRS 13](#) *Fair Value Measurement*, this was referred to as 'fair value less costs to sell'.

# IAS 36- KEY DEFINITIONS



- **Fair value:** the price that would be received to sell an asset or paid to transfer a liability in an orderly trans-action between market participants at the measurement date (see [IFRS 13](#) *Fair Value Measurement*)
- **Value in use:** the present value of the future cash flows expected to be derived from an asset or cash generating unit

# IAS 36 Impairment of Assets



- IAS 36 excludes:
  - inventories
  - assets arising from construction contracts
  - employee benefit assets
  - deferred tax assets
  - financial assets under IAS 39.
  - non-current assets or disposal groups held-for-sale
  - investment property, biological assets based on FV measurements

# IAS 36 Impairment of Assets



Therefore, IAS 36 applies to (among other assets):

- Land & buildings
- machinery and equipment
- investment property carried at cost
- intangible assets
- Goodwill and;
- investments in subsidiaries, associates, and joint ventures carried at cost

# IAS 36 Impairment of Assets



- Changes to IAS 36 focused on impairment tests for intangible assets with indefinite life and goodwill to reflect measurement of non-controlling interest in an acquiree.
- Need to measure inventories at net realizable value IAS 2
- IAS 36 is applicable to all assets .
- Impaired asset should be kept or disposed depending on its future cash flows and the recoverable amount will be based on time value of money as follows;

- ❑ The asset's fair value and not market values especially for assets without observable market like *goodwill, plant, equipment and machinery*. Not appropriate too where a certain asset is a **cash generating unit**
- ❑ Asset's value in use-the present value of the future cash flows expected to be derived from an asset.
- ❑ The higher of the asset's net selling price and value in use.



## IAS 36 Impairment of Assets

- An estimate of recoverable amount should be done any time there is an indication of impairment or it may no longer exist or have decreased.
- Other refinements include;
  - replacement cost as a ceiling
  - appraisal values-verification that the appraisal follows IAS 36
  - net selling price which is the amount obtainable from the sale of an asset in an arm's length.
- Cash flow projections should reflect reasonable and supportable assumptions.

# IAS 36 Impairment of Assets



- Value in use of an asset that generates future cash flows in a foreign currency should be translated into the reporting currency using the spot rate at the balance sheet date
- Discounting future cash flows reflects the time value of money.
- The uncertainties attached to cash flows (opportunity cost) and is based on own's assessment of time value of money and the associated risks.

# IAS 36 Impairment of Assets



- Cash flow projections should be based on the most recent financial budgets /forecasts that have been approved by management.
- When a cash generating unit contains assets with different useful lives;
  - the replacement of assets with shorter lives is considered to be part of the day-to-day servicing of the unit when estimating the future cash flows associated with the unit(asset).

## IAS 36 – Identifying an Asset that May Be Impaired

- Assets
  - end of each reporting period
  - assess for *indications of impairment*
  - if indications of impairment, test for impairment
- Intangibles with indefinite lives, those not yet ready for use, and goodwill
  - annually
  - test for impairment regardless of indications of impairment

# IAS 36 – Identifying an Asset that May Impaired

## Indication of impairment? Consider:

External sources	Internal sources
There has been a significant reduction in the asset's market value.	There is evidence of obsolescence or physical damage of an asset.
A significant change in the technological, market, economic, or legal environment has affected or may adversely affect the entity.	Significant changes with adverse effects have taken place or are expected to take place in how the asset is used.
There has been an increase in market rates of return with a negative effect on the asset's value and recoverable amount.	Internal reports about the asset indicate its performance is or will be worse than expected.
The entity's net assets are greater than its market capitalization.	

# IAS 36 - Value in Use



Value in use is the present value of the future cash flows expected to be derived from an asset or cash generating unit.

The following elements shall be reflected in the calculation of an asset's value in use:

- (a) an estimate of the future cash flows the entity expects to derive from the asset;
- (b) expectations about possible variations in the amount or timing of those future cash flows;
- (c) the time value of money, represented by the current market risk-free rate of interest;
- (d) the price for bearing the uncertainty inherent in the asset;

## IAS 36 - Value in Use

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

## IMPAIRMENT OF GOODWILL

- Test goodwill impairment - end of every financial accounting period.
- Goodwill impairment recognition enables;
  - To make a distinction between acquired goodwill and internally generated one.
  - Device away of allocating it –amortization
  - The useful life of acquired goodwill cannot be predicted nor it's diminishing



## IAS 36 Impairment of Assets

Is a payment made by an acquirer in the anticipation of future economic benefits from assets that are not capable of individually identified and separately recognized.

- It represents the excess of the cost of a business combination over acquirer's interest in the net fair value of the acquiree's identifiable
  - *Asset*
  - *Liabilities*
  - *Contingent liabilities.*

## ALLOCATING GOODWILL TO CASH GENERATING UNITS

- Each unit to which goodwill is allocated should represent the lowest level within which the goodwill is monitored.
- Acquired goodwill should be allocated to each of the acquirer's cash-generating units.
- Testing goodwill at a level appropriate for internal reporting that reflects how they manage their operations is preferred.

# IAS 36 Impairment of Assets



- Allocation can be completed before the end of the first annual period beginning after acquisition date.
- Goodwill of a cash generating unit disposed of should be measured on the basis of the relative values of the operation and the portion of the cash-generating unit retained.
- Reorganization of the business structure requires re-allocation of the goodwill to units affected using a relative value approach.

## MEASUREMENT OF IMPAIREMENT LOSSES

- Screening mechanism – fair value vs carrying amount.
- Allocation to a ‘larger’ unit is an indication of a possible impairment or ‘smaller’ cash-generating, an entity should first test a smaller unit.
- Any excess of carrying amount of a cash-generating unit over its recoverable amount represents a loss for goodwill allocated to other assets of the unit pro rata with their carrying amounts.

# IAS 36 Impairment of Assets



- An impairment loss for a cash-generating unit should be allocated;
  - I. To goodwill
  - II. Intangible assets with no active markets
  - III. To assets whose net selling price is less than their carrying amount
  - IV. Lastly to other assets of the unit in a pro rata basis based on the carrying amount of each asset in the unit.

## REVERSAL OF IMPAIRMENT LOSS OTHER THAN GOODWILL

- An impairment loss should be reversed if and only if there has been a change in the estimates used to determine the asset's recoverable amount since previous impairment loss was recognized.
- Captures future economic benefits from the asset previously not expected
- It is not revaluation as long as reversal amount does not exceed the cost of the asset

# IAS 36 Impairment of Assets



- Provide users with a more useful indication of the potential for future benefits of an asset
- Results from operations will be more fairly stated in the current and future periods since depreciation or amortization will not reflect a previous impairment loss that is no longer relevant.
- Impairment losses are recognized and measured based on estimates. (IAS 8)

## REVERSING GOODWILL IMPAIRMENT LOSSES

- Recognition of reversals of impairment losses for goodwill is prohibited under basis of;
- IAS 38 intangible assets prohibits the recognition of internally generated goodwill to avoid back door capitalization of internally generated goodwill.



# IAS 36 Impairment of Assets



- Including disclosure requirements in the revised standard. IAS 37 provisions, contingent liabilities and contingent assets - disclosing information about uncertainties surrounding the amount and timing of expected outflows
- Current impairment method- comparability between entities applying IFRs and US GAAP.
- If an entity decides to apply IFRS 3 from any date it should also apply IAS 36 from the same date.

# IAS 36 Impairment of Assets



- A transitional goodwill impairment test may not be regarded as the initial year's annual test unless an entity designates the beginning of its fiscal year as at the date for its annual goodwill impairment test.
- Entities encouraged to apply requirements of IAS 36 before its effective date in conjunction with IFRS 3 and IAS 38.

## SUMMARY OF MAIN CHANGES

- Intangible assets to be tested for impairment annually by comparing its carrying amount with its recoverable one.
- Clear assumptions to be made on which current cash flow projections used consistently
- Existence of active markets for the output produced by an asset(s) should be identified as a cash-generating unit, even if some or all of the output is used internally.

# IAS 36 Impairment of Assets



- Goodwill acquired in business combination should be allocated to each cash-generating unit.
- Goodwill associated with the operation disposed of should be measured on the basis of relative values of the operation disposed and the portion of the cash-generating unit retained.
- Any excess of the carrying of a cash-generating unit over its recoverable amount should be recognized as an impairment loss for the goodwill and allocated to other assets

# IAS 36 Impairment of Assets



- Does not require information for evaluating the reliability of the impairment tests for goodwill and indefinite-lived intangibles to be disclosed in aggregate for each segment and separately for cash-generating units within a segment when specified criteria are met.
- Does not require an entity to disclose the amounts by which recoverable amount of cash-generating unit exceeds its carrying amount.

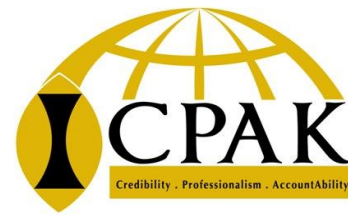
# IAS 36 Impairment of Assets



- Does not require an entity to disclose the value assigned to each key assumption on which management has based its recoverable amount determination, and the amount by which that value must change.
- Requires information about key assumptions to be disclosed for any key assumption that is relevant to the recoverable amount determination of multiple cash-generating activities.



# IAS 36 – Recognizing and Measuring an Impairment Loss for Cash Generating Units and Goodwill



CGU's carrying amount

= carrying amount of all assets used to generate the relevant stream of cash flows

- Includes assets
  - directly involved, and
  - those allocated to the CGU on a reasonable basis



- Average representing the expected return on a company's capital structure.
- Capital structure must reflect market values and long term financing policies
- A rate of return is assigned to each source of capital and weighted in accordance with the proportion that each source of capital contributes to the company's capital structure.
- Used for evaluating capital projects and/or investments.

# IAS 36 WACC



**$WACC = (D/V \times R_d) + (E/V \times R_e)$ , where:**

- **D = Debt**
- **E = Equity**
- **V = E + D**
- **R<sub>d</sub> = borrowing rate or return on debt**
- **R<sub>e</sub> = return on equity**

# IAS 36 WACC- Example

- **Suppose that company has KShs 2 million of debts and 100,000 shares selling at KShs 30 per share (both measured at fair value and reflecting the company's long term financing policy). It's current borrowing rate is 8%, and the CFO thinks that the stock is priced to offer a 15% return.**
- **What is the WACC of company?**

# IAS 36 DISCLOSURE



Disclosure by class of assets: [IAS 36.126]

- impairment losses recognised in profit or loss
- impairment losses reversed in profit or loss
- which line item(s) of the statement of comprehensive income
- impairment losses on revalued assets recognised in other comprehensive income
- impairment losses on revalued assets reversed in other comprehensive income

Disclosure by reportable segment: [IAS 36.129]

- impairment losses recognised
- impairment losses reversed

# IAS 36 EXAMPLE



M is a manufacturing company. It owns a headquarters building that used to be fully occupied for internal use. After down-sizing, half of the building is now used internally and half rented to third parties. The lease agreement with the tenant is for five years.

- What is the cash-generating-unit for the building?

# IAS 36 EXAMPLE



The primary purpose of the building is to serve as a corporate asset, supporting M's manufacturing activities. Therefore, the building as a whole cannot be considered to generate cash inflows that are largely independent of the cash inflows from the entity as a whole. So, it is likely that the cash-generating-unit for the building is M as a whole.

- The building is not held as an investment. Therefore, it would not be appropriate to determine the value in use of the building based on projections of future market related rents.

# Practical Sessions



An entity may have parking garage that is currently being used at 25 percent of capacity. It is held for commercial purposes and management has estimated that it generates a commercial rate of return when usage is at 75 percent of capacity and above. The decline in usage has not been accompanied by a significant increase in parking charges. The asset is regarded as impaired because its carrying amount exceeds its recoverable amount.



# QUESTIONS AND ANSWERS