1. Objective of HKAS 36

The objective of HKAS 36 *Impairment of Assets* is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount.

> ***The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use.*** *(HKAS 36 para. 6)*

An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and HKAS 36 requires the entity to recognise an impairment loss.

> ***Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.***
>
> ***An impairment loss is the amount by which the carrying amount of an asset (or a cash-generating unit) exceeds its recoverable amount.*** *(HKAS 36 para. 6)*

HKAS 36 also specifies when an entity should reverse an impairment loss and prescribes disclosures.

2. Scope of HKAS 36

HKAS 36 shall be applied in accounting for the impairment of all assets, other than:

(a) ***inventories (see HKAS 2*** **Inventories*****);***

(b) ***assets arising from construction contracts (see HKAS 11*** **Construction Contracts*****);***

(c) ***deferred tax assets (see HKAS 12*** **Income Taxes*****);***

(d) ***assets arising from employee benefits (see HKAS 19*** **Employee Benefits*****);***

(e) ***financial assets that are within the scope of HKAS 39*** **Financial Instruments: Recognition and Measurement*****;***

(f) ***investment property that is measured at fair value (see HKAS 40*** **Investment Property*****);***

(g) ***biological assets related to agricultural activity that are measured at fair value less estimated point-of-sale costs (see HKAS 41*** **Agriculture*****);***

(h) ***deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of HKFRS 4*** **Insurance Contracts*****; and***

(i) ***non-current assets (or disposal groups) classified as held for sale in accordance with HKFRS 5*** **Non-current Assets Held for Sale and Discontinued Operations.** *(HKAS 36 para. 1)*[2]

HKAS 36 applies to financial assets classified as:

(a) subsidiaries, as defined in HKAS 27 *Consolidated and Separate Financial Statements*;

(b) associates, as defined in HKAS 28 *Investments in Associates*; and

[1] *This note is sourced from HKAS 36 Impairment of Assets. While the note is aimed at covering all critical points of HKAS 36, a complete and comprehensive coverage should still be the original standard, HKAS 36.*

[2] *All the paragraphs in the HKAS have equal authority now. While certain paragraphs in HKAS are highlighted in bold and italic, the same format is adopted in this note for those paragraphs.*

(c) joint ventures, as defined in HKAS 31 *Interests in Joint Ventures*.

For impairment of other financial assets, refer to HKAS 39.

3. Identifying an Asset that may be Impaired

3.1 Annual assessment on any indication that an asset may be impaired

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. *(HKAS 36 para. 9)*

3.2 Test for impairment on intangible asset and goodwill

Irrespective of whether there is any indication of impairment, an entity shall also:

(a) test an intangible asset with an indefinite useful life or an intangible asset not yet available for use for impairment annually by comparing its carrying amount with its recoverable amount.

This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year. Different intangible assets may be tested for impairment at different times. However, if such an intangible asset was initially recognised during the current annual period, that intangible asset shall be tested for impairment before the end of the current annual period.

(b) test goodwill acquired in a business combination for impairment annually in accordance with paragraphs 80-99 of HKAS 36 (see section 6.2.1). *(HKAS 36 para. 10)*

The ability of an intangible asset to generate sufficient future economic benefits to recover its carrying amount is usually subject to greater uncertainty before the asset is available for use than after it is available for use. Therefore, HKAS 36 requires an entity to test for impairment, at least annually, the carrying amount of an intangible asset that is not yet available for use.

3.3 Indications that an asset may be impaired

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

<u>External sources of information</u>

(a) during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.

(b) significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the 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.

<u>Internal sources of information</u>

(e) evidence is available of obsolescence or physical damage of an asset.

(f) significant changes with an 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. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.

(g) ***evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.*** *(HKAS 36 para. 12)*

The above list is not exhaustive and an entity may identify other indications.

4. Measuring Recoverable Amount

HKAS 36 defines recoverable amount as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. The requirements below for measuring recoverable amount use the term 'an asset' but apply equally to an individual asset or a cash-generating unit.

Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (see section 6 below).

In some cases, estimates, averages and computational short cuts may provide reasonable approximations of the detailed computations illustrated in HKAS 36 for determining fair value less costs to sell or value in use.

4.1 Measuring the Recoverable Amount of an Intangible Asset with an Indefinite Useful Life

As set out section 3.2 above, HKAS 36 requires an intangible asset with an indefinite useful life to be tested for impairment annually by comparing its carrying amount with its recoverable amount, irrespective of whether there is any indication that it may be impaired. However, the most recent detailed calculation of such an asset's recoverable amount made in a preceding period may be used in the impairment test for that asset in the current period, provided that certain criteria set out in HKAS 36 are met.

4.2 Fair Value less Costs to Sell

***Fair value less costs to sell** 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 the costs of disposal.* *(HKAS 36 para. 6)*

***Costs of disposal** are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.* *(HKAS 36 para. 6)*

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.

4.2.1 No binding agreement and active market

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 balance sheet date, from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal.

4.2.3 Costs of disposal

Costs of disposal, other than those that have been recognised as liabilities, are deducted in determining fair value less costs to sell. Examples of such costs are legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale. However, termination benefits (as defined in HKAS 19 *Employee Benefits*) and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

Sometimes, the disposal of an asset would require the buyer to assume a liability and only a single fair value less costs to sell is available for both the asset and the liability.

4.3 Value in Use

> ***<u>Value in use</u> is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.*** *(HKAS 36 para. 6)*

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) time value of money, represented by the current market risk-free rate of interest;

(d) price for bearing the uncertainty inherent in the asset; and

(e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset. *(HKAS 36 para. 30)*

Estimating the value in use of an asset involves the following steps:

(a) estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal; and

(b) applying the appropriate discount rate to those future cash flows.

4.3.1 Basis for Estimates of Future Cash Flows

In measuring value in use an entity shall:

(a) 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.

(b) 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.

(c) 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. *(HKAS 36 para. 33)*

4.3.2 Composition of Estimates of Future 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 (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. *(HKAS 36 para. 39)*

Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:

- ***(a) a future restructuring to which an entity is not yet committed; or***
- ***(b) improving or enhancing the asset's performance.*** *(HKAS 36 para. 44)*

Estimates of future cash flows shall not include:

- ***(a) cash inflows or outflows from financing activities; or***
- ***(b) income tax receipts or payments.*** *(HKAS 36 para. 50)*

The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life shall be the amount that an entity expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the estimated costs of disposal. *(HKAS 36 para. 52)*

4.3.3 Foreign Currency Future Cash Flows

Future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. An entity translates the present value using the spot exchange rate at the date of the value in use calculation.

4.3.4 Discount Rate

The 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.*** *(HKAS 36 para. 55)*

Examination question: Impairment review of equipment

Question *Modified from ACCA Paper 3.6H 2001 December Question 3(b)*

Desolve committed to close one of its subsidiary by the year-end, 31 July 2001. An equipment of the subsidiary was carried at a value of $10 million at 31 July 2001. It was anticipated that the equipment would generate cash flows of $7 million up to 30 November 2001 and that its fair value less costs to sell at 31 July 2001 was $8 million. The equipment was sold on 30 November 2001 for $6 million.

Answers

The commitment by Desolve to close the operations would be an indicator of possible impairment. The equipment has a carrying value of $10 million, a value in use of $7 million and a fair value less costs to sell of $8 million as at 31 July 2001. Thus the carrying value is compared with the higher of the fair value less costs to sell and value in use and as a result the equipment is deemed to be impaired in value to the total of $2 million ($10 million - $8 million).

The question arises as to whether the sale proceeds of $6 million on 30 November 2001 should be taken as a fairer measure of the equipment's value. This post balance sheet event could be taken into account in the impairment review. For example, the income being generated after the year-end could be taken as the disposal proceeds of $6 million plus the cash flows of $7 million, i.e. $13 million. This figure would then be the equipment's recoverable amount, which would mean that the asset is not impaired.

Examination question: Calculation of value of use

Question *Modified from ACCA Paper 3.6H 2003 December Question 3(d)*

Barking, an unlisted company, operates in the house building and commercial property investment development sector. The sector has seen an upturn in activity during recent years and the directors have been considering future plans with a view to determining their impact on the financial statements for the financial year to 30 November 2004.

The directors intend to carry out an impairment review as at 30 November 2004 in order to ascertain whether the carrying amount of goodwill and other non-current assets can be supported by their value in use. The plan is to produce cash flow projections up to 2014 with an average discount rate of 15%

being used in the calculations. The ten year period is to be used as it reflects fairly the long term nature of the assets being assessed. Any subsequent impairment loss is to be charged against the income statement.

Answers

An impairment review in accordance with HKAS 36 will compare the carrying value of the non current assets with their recoverable amount being the higher of fair value less costs to sell and value in use. It is likely that the fair value less costs to sell will be higher than the carrying amount in the case of properties held given the upturn in the business sector. If this is the case then there will be no need to ascertain their value in use as there will be no impairment. The main problem with the planned impairment test is the length of time over which the cash flows are being estimated and the discount rate being used.

HKAS 36 (para 33) states that projections should only cover a maximum period of five years unless a longer period can be justified. Management will have to demonstrate the accuracy of these projections based on past experience. Additionally the discount rate being used is quite high and the projections are likely to be inaccurate given the length of time which they are covering and given the industrial sector in which the company is operating. Therefore, a lower discount rate and a shorter time frame may have to be used for the projections.

An impairment loss involving a revalued asset should be set first against any revaluation surplus on the asset and only thereafter against the income statement. Thus if there is an impairment loss, then the assets should be itemised and segregated into those which have and have not been revalued and the loss treated accordingly.

5. Recognising and Measuring an Impairment Loss

If, and only 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. *(HKAS 36 para. 59)*

An impairment loss shall be recognised 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 HKAS 16 **Property, Plant and Equipment*****). Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.*** *(HKAS 36 para. 60)*

When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognise a liability if, and only if, that is required by another Standard. *(HKAS 36 para. 62)*

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. *(HKAS 36 para. 63)*

If an impairment loss is recognised, any related deferred tax assets or liabilities are determined in accordance with HKAS 12 *Income Taxes* by comparing the revised carrying amount of the asset with its tax base.

6. Cash-generating Units and Goodwill

A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. *(HKAS 36 para. 6)*

6.1 Identifying the Cash-generating Unit to Which an Asset Belongs

If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit). *(HKAS 36 para. 66)*

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

(a) it value in use cannot be estimated to be close to its fair value less costs to sell; and

(b) it does not generate cash inflows that are largely independent of those from other assets.

In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit.

> **Example – Cash-generating unit**
>
> A mining entity owns a private railway to support its mining activities. 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 the private railway since its value in use cannot be determined and is probably different from scrap value. Thus, the entity estimates the recoverable amount of the cash-generating unit to which the private railway belongs, i.e. the mine as a whole.*

6.1.1 Lowest aggregation of assets

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 – Lowest aggregation of assets**
>
> 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, 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 five routes together. The cash-generating unit for each route is the bus company as a whole.*

6.1.2 Largely independent cash inflows

Cash inflows are inflows of cash and cash equivalents received from parties external to the entity. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an entity considers various factors including:

- how management monitors the entity's operations (such as by products or locations)
- how management makes decisions about continuing or disposing of the entity's assets and operations

If an active market exists for the output produced by an asset or group of assets, that asset or group of assets shall be identified as a cash-generating unit, even if some or all of the output is used internally.

If the cash inflows generated by any asset or cash-generating unit are affected by internal transfer pricing, an entity shall use management's best estimate of future price(s) that could be achieved in arm's length transactions in estimating:

(a) the future cash inflows used to determine the asset's or cash-generating unit's value in use; and

(b) the future cash outflows used to determine the value in use of any other assets or cash-generating units that are affected by the internal transfer pricing. *(HKAS 36 para. 70)*

> ***An <u>active market</u> is a market in which all the following conditions exist:***
>
> ***(a) the items traded within the market are homogeneous;***
>
> ***(b) willing buyers and sellers can normally be found at any time; and***
>
> ***(c) prices are available to the public.*** *(HKAS 36 para. 6)*

Even if part or all of the output produced by an asset or a group of assets is used by other units of the entity (e.g. products at an intermediate stage of a production process), this asset or group of assets forms a separate cash-generating unit if the entity could sell the output on an active market. This is because the asset or group of assets could generate cash inflows that would be largely independent of the cash inflows from other assets or groups of assets.

6.1.3 Cash-generating unit identified consistently

Cash-generating units shall be identified consistently from period to period for the same asset or types of assets, unless a change is justified. *(HKAS 36 para. 72)*

If there is any necessary change on the group of assets, HKAS 36 requires disclosures about the cash-generating unit, if an impairment loss is recognised or reversed for the cash-generating unit (see section 8 below).

6.2 Recoverable Amount and Carrying Amount of a Cash-generating Unit

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. *(HKAS 36 para. 75)*

1) Carrying amount of a cash-generating unit

The carrying amount of a cash-generating unit:

(a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use; and

(b) does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.

This is because fair value less costs to sell and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognised.

2) All assets in a cash-generating unit grouped for recoverability assessment

When assets are grouped for recoverability assessments, it is important to include in the cash-generating unit all assets that generate or are used to generate the relevant stream of cash inflows. Otherwise, the cash-generating unit may appear to be fully recoverable when in fact an impairment loss has occurred.

3) Consider some recognised liabilities if necessary

It may be necessary to consider some recognised liabilities to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to assume the liability.

To perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount.

Example – Consideration of recognised liabilities

A company operates a mine with a carrying amount of $1,000 in a country where legislation requires that the owner must restore the site on completion of its mining operations. A provision for such costs was recognised as part of the cost of the mine and is being depreciated over the mine's useful life. The carrying amount of the provision for restoration costs is $500, which is equal to the present value of the restoration costs.

The entity is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The entity has received various offers to buy the mine at a price of around $800. This price reflects the fact that the buyer will assume the obligation to restore the mine. Disposal costs for the mine are negligible. The value in use of the mine is approximately $1,200, excluding restoration costs.

Result of the impairment test:

The cash-generating unit's fair value less costs to sell is $800. This amount considers restoration costs that have already been provided for.

The value in use for the cash-generating unit is determined after consideration of the restoration costs and is estimated to be $700 ($1,200 less $500).

The carrying amount of the cash-generating unit is $500, which is the carrying amount of the mine ($1,000) less the carrying amount of the provision for restoration costs ($500).

Therefore, the recoverable amount of the cash-generating unit exceeds its carrying amount.

6.2.1 Goodwill

1) Allocating Goodwill to Cash-generating Units

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 are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units.

Each unit or group of units to which the goodwill is so allocated shall:

- ***(a) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and***
- ***(b) not be larger than a segment based on either the entity's primary or the entity's secondary reporting format determined in accordance with HKAS 14*** **Segment Reporting.** *(HKAS 36 para. 80)*

Applying the above requirements results in goodwill being tested for impairment at a level that reflects the way an entity manages its operations and with which the goodwill would naturally be associated. Therefore, the development of additional reporting systems is typically not necessary.

a) Time of allocation

If the initial allocation of goodwill acquired in a business combination cannot be completed before the end of the annual period in which the business combination is effected, that initial allocation shall be completed before the end of the first annual period beginning after the acquisition date. *(HKAS 36 para. 84)*

In accordance with HKFRS 3 *Business Combinations*, if the initial accounting for a business combination can be determined only provisionally by the end of the period in which the combination is effected, the acquirer:

- (a) accounts for the combination using those provisional values; and
- (b) recognises any adjustments to those provisional values as a result of completing the initial accounting within twelve months of the acquisition date.

In such circumstances, it might also not be possible to complete the initial allocation of the goodwill acquired in the combination before the end of the annual period in which the combination is effected. When this is the case, the entity discloses the information required by HKAS 36 (paragraph 133).

b) Allocation upon disposal of an operation

If goodwill has been allocated to a cash-generating unit and the entity disposes of an operation within that unit, the goodwill associated with the operation disposed of shall be:

(a) included in the carrying amount of the operation when determining the gain or loss on disposal; and

(b) measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of. *(HKAS 36 para. 75)*

Example – Allocation upon disposal of a operation

An entity sells for $100 an operation that was part of a cash-generating unit to which goodwill has been allocated. The goodwill allocated to the unit cannot be identified or associated with an asset group at a level lower than that unit, except arbitrarily. The recoverable amount of the portion of the cash-generating unit retained is $300.

Because the goodwill allocated to the cash-generating unit cannot be non-arbitrarily identified or associated with an asset group at a level lower than that unit, the goodwill associated with the operation disposed of is measured on the basis of the relative values of the operation disposed of and the portion of the unit retained. Therefore, 25% of the goodwill allocated to the cash-generating unit is included in the carrying amount of the operation that is sold.

c) Reallocation

If an entity reorganises its reporting structure in a way that changes the composition of one or more cash-generating units to which goodwill has been allocated, the goodwill shall be reallocated to the units affected. This reallocation shall be performed using a relative value approach similar to that used when an entity disposes of an operation within a cash-generating unit, unless some other method is better reflects the allocation.

Example – Reallocation

Goodwill had previously been allocated to cash-generating unit A. The goodwill allocated to A cannot be identified or associated with an asset group at a level lower than A, except arbitrarily. A is to be divided and integrated into 3 other cash-generating units, B, C and D.

Because the goodwill allocated to A cannot be non-arbitrarily identified or associated with an asset group at a level lower than A, it is reallocated to units B, C and D on the basis of the relative values of the three portions of A before those portions are integrated with B, C and D.

2) Testing Cash-generating Units with Goodwill for Impairment

When goodwill relates to a cash-generating unit but has not been allocated to that unit, the unit shall be tested for impairment, whenever there is an indication that the unit may be impaired, by comparing the unit's carrying amount, excluding any goodwill, with its recoverable amount. Any impairment loss shall be recognised in accordance with paragraph 104 of HKAS 36 (see section 6.3 below). *(HKAS 36 para. 88)*

A cash-generating unit to which goodwill has been allocated shall be tested for impairment annually, and whenever there is an indication that the unit may be impaired, by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit. If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit shall be regarded as not impaired.

If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity shall recognise the impairment loss in accordance with paragraph 104 of HKAS 36 (see section 6.3 below). *(HKAS 36 para. 90)*

3) Minority Interest

In accordance with HKFRS 3, goodwill recognised in a business combination represents the goodwill acquired by a parent based on the parent's ownership interest, rather than the amount of goodwill controlled by the parent as a result of the business combination. Thus, goodwill attributable to a minority interest is not recognised in the parent's consolidated financial statements. For the purpose of impairment testing a non-wholly-owned cash-generating unit with goodwill, additional adjustments as set out in HKAS 36 are required in testing for the impairment of the unit.

4) Timing of Impairment Tests

The annual impairment test for a cash-generating unit to which goodwill has been allocated may be performed at any time during an annual period, provided the test is performed at the same time every year. Different cash-generating units may be tested for impairment at different times.

However, if some or all of the goodwill allocated to a cash-generating unit was acquired in a business combination during the current annual period, that unit shall be tested for impairment before the end of the current annual period. *(HKAS 36 para. 96)*

If the assets constituting the cash-generating unit to which goodwill has been allocated are tested for impairment at the same time as the unit containing the goodwill, they shall be tested for impairment before the unit containing the goodwill. Similarly, if the cash-generating units constituting a group of cash-generating units to which goodwill has been allocated are tested for impairment at the same time as the group of units containing the goodwill, the individual units shall be tested for impairment before the group of units containing the goodwill.

The most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit to which goodwill has been allocated may be used in the impairment test of that unit in the current period provided all of the following criteria are met:

- ***(a) the assets and liabilities making up the unit have not changed significantly since the most recent recoverable amount calculation;***
- ***(b) the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; and***
- ***(c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the current carrying amount of the unit is remote.*** *(HKAS 36 para. 99)*

6.2.2 Corporate Assets

Corporate assets are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units. *(HKAS 36 para. 6)*

Corporate assets include group or divisional assets such as the headquarter office or EDP equipment. As corporate assets do not generate separate cash inflows, the recoverable amount of an individual corporate asset cannot be determined unless management has decided to dispose of the asset. In consequence, if there is an indication that a corporate asset may be impaired, recoverable amount is determined for the cash-generating unit or group of cash-generating units to which the corporate asset belongs, and is compared with the carrying amount of this cash-generating unit or group of cash-generating units.

In testing a cash-generating unit for impairment, an entity shall identify all the corporate assets that relate to the cash-generating unit under review. If a portion of the carrying amount of a corporate asset:

- ***(a) can be allocated on a reasonable and consistent basis to that unit, the entity shall compare the carrying amount of the unit, including the portion of the carrying amount of the corporate asset allocated to the unit, with its recoverable amount.***

Any impairment loss shall be recognised in accordance with paragraph 104 of HKAS 36 (see section 6.3 below).

(b) ***cannot be allocated on a reasonable and consistent basis to that unit, the entity shall:***

(i) ***compare the carrying amount of the unit, excluding the corporate asset, with its recoverable amount and recognise any impairment loss in accordance with paragraph 104 of HKAS 36*** (see section 6.3 below);

(ii) ***identify the smallest group of cash-generating units that includes the cash-generating unit under review and to which a portion of the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis; and***

(iii) ***compare the carrying amount of that group of cash-generating units, including the portion of the carrying amount of the corporate asset allocated to that group of units, with the recoverable amount of the group of units. Any impairment loss shall be recognised in accordance with paragraph 104 of HKAS 36*** (see section 6.3 below). *(HKAS 36 para. 102)*

6.3 Impairment Loss for a Cash-generating Unit

An impairment loss shall be recognised for a cash-generating unit (the smallest group of cash-generating units to which goodwill or a corporate asset has been allocated) if, and only if, the recoverable amount of the unit (group of units) is less than the carrying amount of the unit (group of units).

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

(a) ***first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and***

(b) ***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).***

These reductions in carrying amounts shall be treated as impairment losses on individual assets and recognised in accordance with paragraph 60 of HKAS 36 (see section 5 above). *(HKAS 36 para. 104)*

In allocating an impairment loss in accordance with the above paragraph, an entity shall not reduce the carrying amount of an asset below the highest of:

(a) ***its fair value less costs to sell (if determinable);***

(b) ***its value in use (if determinable); and***

(c) ***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). *(HKAS 36 para. 105)*

If it is not practicable to estimate the recoverable amount of each individual asset of a cash-generating unit, HKAS 36 requires an arbitrary allocation of an impairment loss between the assets of that unit, other than goodwill, because all assets of a cash-generating unit work together. If the recoverable amount of an individual asset cannot be determined:

(a) an impairment loss is recognised for the asset if its carrying amount is greater than the higher of its fair value less costs to sell and the results of the allocation procedures described in the above paragraphs; and

(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.

Example

A machine has suffered physical damage but is still working. Its fair value less costs to sell is less than its carrying amount. The machine does not generate independent cash inflows, but the smallest identifiable group of assets that includes the machine and generates cash inflows that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The production line's recoverable amount shows that the production line as a whole is not impaired.

Assumption 1: budgets/forecasts approved by management reflect no commitment of management to replace the machine.

The recoverable amount of the machine alone cannot be estimated because the machine's value in use:

(a) may differ from its fair value less costs to sell; and

(b) can be determined only for the cash-generating unit to which the machine belongs (the production line).

The production line is not impaired. Therefore, no impairment loss is recognised for the machine. Nevertheless, the entity may need to reassess the depreciation period or the depreciation method for the machine. Perhaps a shorter depreciation period or a faster depreciation method is required to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are expected to be consumed by the entity.

Assumption 2: budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future. Cash flows from continuing use of the machine until its disposal are estimated to be negligible.

The machine's value in use can be estimated to be close to its fair value less costs to sell. Therefore, the recoverable amount of the machine can be determined and no consideration is given to the cash-generating unit to which the machine belongs (i.e. the production line). Because the machine's fair value less costs to sell is less than its carrying amount, an impairment loss is recognised for the machine.

After the above requirements (paragraphs 104 and 105 of HKAS 36) ***have been applied, a liability shall be recognised for any remaining amount of an impairment loss for a cash-generating unit if, and only if, that is required by another Standard.*** *(HKAS 36 para. 108)*

Examination question: Impairment review with goodwill

Question *Modified from ACCA Paper 3.6H 2001 December Question 4(iii)*

Nettle had acquired a competitor organisation, Leaf, on 1 October 1999 for $150 million. The fair value of the net assets at that date was $130 million and the acquired business was combined with Nettle's existing business and did not retain its separate identity.

At the time of the acquisition the fair value of the net assets of Nettle was $240 million, the value in use was $250 million and their carrying amount was $180 million. Goodwill is written off over 5 years.

At 30 September 2001, the combined entity's net tangible assets had a carrying value of $310 million. There is no reliable estimate of the net selling price of the assets but the directors have estimated that the cash flows for the year ended 30 September 2002 would be $19 million and for the year ended 30 September 2003 would be $26 million. They feel that there would be steady growth in cash flows of 2% thereafter after eliminating the effect of inflation. (Assume inflation of 2%, a pre tax discount rate of 12% and pre-tax discount rate adjusted to reflect growth in cash flows and inflation of 8%.)

The directors feel that the market in which they operate has changed significantly because of the entrance of a major competitor which has adversely affected the company's profitability. They are wondering whether they should review their assets for impairment as the first year review carried out on 30 September 2000 indicated that future cash flows would meet their target amounts and that there was no impairment of the company's assets.

(10 marks)

Answers

The entrance of the major competitor in the market place and the occurrence of the change in profitability may indicate that impairment in the value of non-current assets and goodwill has occurred. These circumstances will trigger an impairment review under HKAS 36 which involves the comparison of the carrying value of the net assets with their recoverable amount.

The following discussion is based upon the assumption that the merged operations are a single combined income generating unit. When the competitor organisation was merged with the existing business, the result was that both purchased and unrecognised internally generated goodwill were contained in the merged business.

		$m
Leaf -	Acquisition cost	150
	Fair value of net assets	(130)
	Goodwill	20
Nettle -	Value in use at acquisition	250
	Fair value of assets at acquisition	(240)
	Internally generated goodwill	10

As there are circumstances which have indicated the potential impairment of goodwill, then an impairment test must be carried out even though the first year review was satisfactory. In principle, any impairment loss should exclude internally generated goodwill. However because of the cost and difficulty of distinguishing items relating to internally generated goodwill (especially if businesses are merged), the impairment loss is not required to be allocated between purchased and internally generated goodwill.

Calculation of impairment loss at 30 September 2001

	$m
Carrying amount of tangible net assets	310
Carrying amount of goodwill	
($20 million – amortisation 2 years $8 million)	12
Total net asset value	322
Value in use	307
Impairment	15

Value in use = $19 million/(1.12) + $26 million/($1.12^2$) + $26 million x 1·02 x 1·02/(0.08 x 1.12^2)
= $307 million

The impairment is allocated first to purchased goodwill and then to tangible net assets. Thus purchased goodwill will be written down by $12 million and tangible net assets by $3 million. There will be an increase in the charge to the income statement of $15 million for the impairment loss.

7. Reversing an Impairment Loss

7.1 Annual assessment on any indication of reversal on recognised 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. *(HKAS 36 para. 110)*

In assessing 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, an entity shall consider, as a minimum, the following indications:

External sources of information

(a) the asset's market value has increased significantly during the period.

(b) significant changes with a favourable effect on the entity have taken place during the period, or will take place in the near future, in the 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 during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially. Internal sources of information

(d) significant changes with a favourable 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, the asset is used or is expected to be used. 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 is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected. *(HKAS 36 para. 111)*

Indications of a potential decrease in an impairment loss in the above paragraph mainly mirror the indications of a potential impairment loss set out in section 3.3. If there is an indication that an impairment loss recognised for an asset other than goodwill may no longer exist or may have decreased, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value may need to be reviewed and adjusted in accordance with HKAS 36 applicable to the asset, even if no impairment loss is reversed for the asset.

7.2 Recognition of reversal on recognised impairment loss

An impairment loss recognised 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 recognised. If this is the case, the carrying amount of the asset shall, except as described in paragraph 117 (see section 7.1 below)***, be increased to its recoverable amount. That increase is a reversal of an impairment loss.*** *(HKAS 36 para. 114)*

A reversal of an impairment loss reflects an increase in the estimated service potential of an asset, either from use or from sale, since the date when an entity last recognised an impairment loss for that asset. HKAS 36 (see section 8 below) requires an entity to identify the change in estimates that causes the increase in estimated service potential. Examples of estimate changes include:

(a) a change in the basis for recoverable amount (i.e. whether recoverable amount is based on fair value less costs to sell or value in use);

(b) if recoverable amount was based on value in use, a change in the amount or timing of estimated future cash flows or in the discount rate; or

(c) if recoverable amount was based on fair value less costs to sell, a change in estimate of the components of fair value less costs to sell.

An asset's value in use may become greater than the asset's carrying amount simply because the present value of future cash inflows increases as they become closer. However, the service potential of the asset has not increased. Therefore, an impairment loss is not reversed just because of the passage of time (sometimes called the 'unwinding' of the discount), even if the recoverable amount of the asset becomes higher than its carrying amount.

7.3 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 amortisation or depreciation) had no impairment loss been recognised for the asset in prior years. *(HKAS 36 para. 117)*

A reversal of an impairment loss for an asset other than goodwill shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, the revaluation model in HKAS 16 **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.*** *(HKAS 36 para. 119)*

After a reversal of an impairment loss is recognised, 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. *(HKAS 36 para. 121)*

7.4 Reversing an Impairment Loss for a Cash-generating Unit

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 (see section 7.3 above). *(HKAS 36 para. 122)*

In allocating a reversal of an impairment loss for a cash-generating unit in accordance with the above paragraph, 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 amortisation 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. *(HKAS 36 para. 123)*

7.3 Reversing an Impairment Loss for Goodwill

An impairment loss recognised for goodwill shall not be reversed in a subsequent period. *(HKAS 36 para. 124)* HKAS 38 *Intangible Assets* prohibits the recognition of internally generated goodwill. Any increase in the recoverable amount of goodwill subsequent to the recognition of an impairment loss for that goodwill is likely to be an increase in internally generated goodwill, rather than a reversal of the impairment loss recognised for the acquired goodwill.

8. Disclosure

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 recognised directly in equity during the period.*** *(HKAS 36 para. 126)*

An entity that reports segment information in accordance with HKAS 14 **Segment Reporting** ***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.*** *(HKAS 36 para. 129)*

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.***

(c) ***for an individual asset:***

  (j) ***the nature of the asset; and***

  (ii) ***if the entity reports segment information in accordance with HKAS 14, the reportable segment to which the asset belongs, based on the entity's primary reporting format.***

(d) ***for a cash-generating unit:***

  (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 as defined in HKAS 14);***

  (ii) ***the amount of the impairment loss recognised or reversed by class of assets and, if the entity reports segment information in accordance with HKAS 14, 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. *(HKAS 36 para. 130)*

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 the above paragraph:

(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. *(HKAS 36 para. 131)*

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 reporting date(see section 6.2.1 above)***, the amount of the unallocated goodwill shall be disclosed together with the reasons why that amount remains unallocated.*** *(HKAS 36 para. 133)*

8.1 Estimates used to Measure Recoverable Amounts of Cash-generating Units Containing Goodwill or Intangible Assets with Indefinite Useful Lives

An entity shall disclose the information required by (a)-(f) for each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives:

(a) the carrying amount of goodwill allocated to the unit (group of units).

(b) the carrying amount of intangible assets with indefinite useful lives allocated to the unit (group of units).

(c) the basis on which the unit's (group of units') recoverable amount has been determined (i.e. value in use or fair value less costs to sell).

(d) if the unit's (group of units') recoverable amount is based on value in use:

(i) a description of each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive.

(ii) a description of management's approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.

(iii) the period over which management has projected cash flows based on financial budgets/forecasts approved by management and, when a period greater than five years is used for a cash-generating unit (group of units), an explanation of why that longer period is justified.

(iv) the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts, and the justification for using any growth rate that exceeds the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market to which the unit (group of units) is dedicated.

(v) the discount rate(s) applied to the cash flow projections.

(e) if the unit's (group of units') recoverable amount is based on fair value less costs to sell, the methodology used to determine fair value less costs to sell. If fair value less costs to sell is not determined using an observable market price for the unit (group of units), the following information shall also be disclosed:

(i) a description of each key assumption on which management has based its determination of fair value less costs to sell. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive.

(ii) a description of management's approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.

***(f)** if a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount:*

(i) the amount by which the unit's (group of units') recoverable amount exceeds its carrying amount.

(ii) the value assigned to the key assumption.

(iii) the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's (group of units') recoverable amount to be equal to its carrying amount. (HKAS 36 para. 134)

If some or all of the carrying amount of goodwill or intangible assets with indefinite useful lives is allocated across multiple cash-generating units (groups of units), and the amount so allocated to each unit (group of units) is not significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, that fact shall be disclosed, together with the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to those units (groups of units).

In addition, if the recoverable amounts of any of those units (groups of units) are based on the same key assumption(s) and the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to them is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, an entity shall disclose that fact, together with:

(a) the aggregate carrying amount of goodwill allocated to those units (groups of units).

(b) the aggregate carrying amount of intangible assets with indefinite useful lives allocated to those units (groups of units).

(c) a description of the key assumption(s).

(d) a description of management's approach to determining the value(s) assigned to the key assumption(s), whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.

(e) if a reasonably possible change in the key assumption(s) would cause the aggregate of the units' (groups of units') carrying amounts to exceed the aggregate of their recoverable amounts:

(i) the amount by which the aggregate of the units' (groups of units') recoverable amounts exceeds the aggregate of their carrying amounts.

(ii) the value(s) assigned to the key assumption(s).

(iii) the amount by which the value(s) assigned to the key assumption(s) must change, after incorporating any consequential effects of the change on the other variables used to measure recoverable amount, in order for the aggregate of the units' (groups of units') recoverable amounts to be equal to the aggregate of their carrying amounts. (HKAS 36 para. 135)

Examination question: Impairment review

Question *Modified from ACCA Paper 3.6H 2004 June Question 2(c)*

Fish and Near, public limited companies, constitute the vehicle sales segment. They were wholly acquired on 1 May 2001 from Motors, a public limited company, for $30 million when the fair value of their net assets was $22 million.

At 30 April 2002, when the carrying value of the net assets of Fish and Near were respectively $20 million and $5 million, an impairment review was carried out because of the impact of a new tax law on the goodwill and an impairment loss recognised. However, the actual net cash flows for the years 2003 and 2004 were higher than forecast, because of the pessimistic nature of the original forecasts and a change in economic conditions. The group revised the calculation of the recoverable amount of the segment based on a revision of all future cash flows from 1 May 2004. The recoverable amount of Fish and Near at the respective dates is set out below:

	Recoverable amount at 30.4.2002 (original cash flows)	Recoverable amount at 30.4.2004 (revised cash flows)
	$m	$m
Fish	16	29
Near	8	10

The depreciated historical cost of Fish and Near's net assets at 30 April 2004 was $26 million and $8 million. Goodwill is written off over four years. The tax law is still in place at 30 April 2004.

Describe with suitable calculations, the nature of any impairment reviews that would have been carried out on the net assets of Fish and Near at 30 April 2002 and 30 April 2004. (7 marks)

Answers

As both Fish and Near are making losses and an impairment review was undertaken two years previously which subsequently was found to be flawed in terms of the accuracy of the cash flow forecasts, it would seem that a further impairment review of the two companies should be undertaken at 30 April 2004. As Fish and Near were part of the same investment and are involved in similar parts of the business, the two subsidiaries can be combined for the impairment review. There would be a difficulty in allocating the goodwill to the two subsidiaries, therefore, a two tier impairment review will be undertaken.

Impairment review at 30 April 2002 ($ million):

	Fish	Near	Goodwill	Total
Net assets – carrying value	20	5	6	31
Recoverable amount	16	8		24
Impairment	14	Not impaired	3	17
			3	

There is an impairment loss of $4 million on the net assets of Fish. The recoverable amount of the net assets of Fish and Near is $7 million less than the carrying value and, therefore, a further impairment loss of $3 million is recognised against goodwill. (Goodwill has been amortised for one year as at 30 April 2002.)

The actual cash flows were better than forecast and, therefore, it is possible that a reversal of the impairment loss may have taken place.

Impairment Review at 30 April 2004 ($ million):

	Fish	Near	Goodwill
Net assets – carrying value (35 – 12)	23	8	1
Depreciated historical cost	26	8	2
Reversal of impairment loss	13	–	–

HKSSAP31 states that where there has been a favourable change in estimates then a reversal of the impairment loss can be recognised. The carrying value of the net assets can be increased up to the lower of the recoverable amount ($29 million) and the net asset's depreciated historical cost ($26 million). The increase is recognised in the income statement. The net assets of Near had not been impaired at 30 April 2002. The impairment loss on goodwill is not reversed as the tax law is still in place and this was the event that led to the recognition of an impairment in goodwill. An impairment loss involving a revalued asset should be set first against any revaluation surplus on the asset and only thereafter against the income statement. Thus if there is an impairment loss, then the assets should be itemised and segregated into those which have and have not been revalued and the loss treated accordingly.