Skillset: impairment of assets

Andrew Coulson talks you through IAS 36 – Impairment of Assets

This article explains the principal requirements of IAS 36 Impairment of Assets. The standard applies to property, plant and equipment and intangible assets, amongst others, but it does not apply to inventories.

When is an asset impaired?

An asset is impaired when its carrying amount exceeds its recoverable amount.

Where:

- The carrying amount of an asset is the amount at which it is recognised in the statement of financial position after deducting accumulated depreciation, or amortisation in the case of intangibles, and previous accumulated impairment losses.
- The recoverable amount of an asset is the higher of its fair value less costs of disposal and its value in use.
- Fair value less costs of disposal is the price that would be received from the sale of an asset in an orderly transaction between market participants at the measurement date, less the costs of disposal – for example, legal costs, stamp duty and the costs of removing the asset.
- Value in use is the present value of the future cash flows expected to be derived from an asset in respect of its continuing use and ultimate disposal.

This can be illustrated as follows:

An asset is impaired when:

Carrying amount **exceeds** Recoverable amount

the higher of:

Fair value less costs of disposal

Value in use

Example

Inspire Ltd carries out impairment reviews of three of the company's assets.

The following information is relevant:

	Carrying amount	Fair value less costs of disposal	Value in use
	£	£	£
Asset A	9,000	6,000	7,000
Asset B	17,000	19,000	13,000
Asset C	26,000	21,000	24,000

Which of these assets, if any, will be impaired?

Solution

Asset A

This asset is impaired as the carrying amount of £9,000 exceeds the recoverable amount of £7,000 (the higher of £7,000 and £6,000).

Asset B

The carrying amount of £17,000 is less than the recoverable amount of £19,000 (the higher of £19,000 and £13,000), and so this asset is not impaired.

Asset C

This asset is impaired as the carrying amount of £26,000 exceeds the recoverable amount of £24,000 (the higher of £24,000 and £21,000).

Indications of impairment

IAS 36 requires an entity to undertake an impairment review of an asset when there is some indication that the asset may be impaired; although intangible assets with an indefinite useful life and goodwill acquired in a business combination must be tested for impairment on an annual basis.

Some examples of indications that an asset may be impaired are:

(i) The market value of the asset has fallen significantly during the period.
(ii) A significant change has taken place (or will take place in the near future) in the technological, market, economic or legal environment in which the entity operates, or the market in which the asset is involved.
(iii) The asset has suffered physical damage or has become obsolete.
(iv) A significant change has occurred (or is expected to occur in the near future) in the extent to which the asset is used or the manner in which it is used (for example, the asset becoming idle or there being plans to restructure or discontinue the operation to which the asset belongs or dispose of the asset earlier than expected).
(v) A significant increase in market interest rates has occurred which is likely to affect the discount rate used to calculate the present value of the future cash flows associated with the asset, and thus its value in use and potentially also its recoverable amount.
(vi) There is evidence which indicates that the economic performance of the asset is (or will be) worse than expected (for example, cash flows for operating and maintaining the asset are significantly higher than those budgeted; the cash flows or operating profit flowing from the asset are significantly worse than those budgeted; or there is a significant decline in the future cash flows or operating profit expected to be derived from the asset).

Accounting treatment of an impairment loss

When an asset is impaired, its carrying amount must be reduced to its recoverable amount in the statement of financial position. The amount of the reduction is an impairment loss.

An impairment loss must be recognised as an expense in the statement of profit or loss, unless the asset has previously been revalued upwards, in which case the loss must be recognised (as a negative figure) in other comprehensive income, to the extent of any credit balance existing in the revaluation reserve in respect of that same asset, with the remainder of the loss then being recognised as an expense in profit or loss. The decrease recognised in other comprehensive income reduces the amount of the revaluation reserve in equity.

After recognition of an impairment loss, the depreciation (amortisation) charge will need to be adjusted for future accounting periods.

Example

Create Ltd is preparing financial statements for the year ended 31 December 20X1.

An extract from the trial balance in respect of a building is as follows:

	£	£
Building (at valuation)	200,000	
Accumulated depreciation at 31.12.20X1		40,000
Revaluation reserve at 31.12.20X1		32,000

Following a sharp decline in property prices, an impairment review was conducted in respect of the building. Its recoverable amount is £110,000. The building had previously been revalued and was used as an administration office.

Show the amounts that must be recognised in the financial statements in respect of the impairment review.

Solution

The asset is impaired as its carrying amount of £160,000 (£200,000 - £40,000) exceeds its recoverable amount of £110,000.

The carrying amount will be reduced to £110,000 and an impairment loss of £50,000 (£160,000 - £110,000) will be recognised, with £32,000 of this being shown in other comprehensive income (the amount of the credit balance in the revaluation reserve in respect of the asset) and £18,000 as an administrative expense.

The revaluation reserve included in equity will be reduced to £Nil.

Summary

- An asset is impaired when its carrying amount exceeds its recoverable amount.
- The recoverable amount of an asset is the higher of its fair value less costs of disposal and its value in use.
- Impairment reviews must be completed annually for purchased goodwill and for intangible assets with indefinite useful lives. Other assets need only be tested for impairment if there is an indication that impairment may have occurred.
- An impairment loss is usually recognised as an expense, but, if the asset has previously been revalued upwards, the loss must first be deducted from the revaluation surplus and recognised in other comprehensive income, with the excess then being recognised as an expense.