



HM TREASURY

Financial Reporting Advisory Board Paper

IAS 36 *Impairment of Assets*

Issue:	The application of IAS 36 <i>Impairment of Assets</i> in the context of resource and other accounts covered by the Government Financial Reporting Manual (FReM)
Impact on guidance:	The proposed text in Annex A relates to the IFRS-based FReM.
IAS/IFRS adaptation?	Yes – to mirror budgetary treatment
IPSAS compliant?	Yes
Interpretation for the public sector context?	Yes – please see proposed text in Annex A interpreting value in use
Impact on budgetary regime?	None with adaptation
Alignment with National Accounts	Yes
Impact on Estimates?	None
Recommendation:	That the Board agrees that IAS 36 applies subject to the interpretation and adaptation contained in Annex A.
Timing:	Not yet known: depends on future decision on date for moving to EU-adopted IFRS.

DETAIL

Background

1. The objective of IAS 36 *Impairment of Assets* is to ensure that assets are carried at no more than their recoverable amount. 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 the Standard requires the recognition of an impairment loss.

2. The Standard shall be applied in accounting for the impairment of all assets, other than:
 - a. Inventories (IAS 2);
 - b. Assets arising from construction contracts (IAS 11);
 - c. Deferred tax assets (IAS 12);
 - d. Assets arising from employee benefits (IAS 19);
 - e. Financial assets within the scope of IAS 39;
 - f. Investment property carried at fair value (IAS 40);
 - g. Biological assets (IAS 41);
 - h. Assets arising under insurance contracts (IFRS 4);
 - i. Assets held for sale in accordance with IFRS 5.

3. Therefore, IAS 36 applies to (among other assets) land, buildings, machinery and equipment, investment property carried at cost, intangible assets, and assets carried at revalued amounts under IAS 16 and IAS 38.

Definitions

4. Carrying amount is the amount at which an asset is recognized in the balance sheet after deducting accumulated depreciation and accumulated impairment losses.
5. Fair value is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties.
6. Value in use is the present value of the future cash flows expected to be derived from an asset (but please see interpretation for the public sector context in Annex A).
7. Recoverable amount is the higher of an asset's fair value less costs to sell and its value in use.
8. An asset is impaired when its carrying amount exceeds its recoverable amount.

Identifying an asset that may be impaired

9. At each balance sheet date an entity shall review all assets to look for any indication that an asset may be impaired. If there is an indication that an asset may be impaired, the entity shall estimate the recoverable amount of the asset.
10. The recoverable amounts of the following types of intangible assets should be measured annually whether or not there is any indication that it may be impaired:
 - a. An intangible asset with an indefinite useful life;
 - b. An intangible asset not yet available for use;

- c. Goodwill acquired in a business combination.

Indications of impairment

11. In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following external and internal indications. The list is not exhaustive:

- a. Market value declines;
- b. Negative changes in technology, markets, economy or laws;
- c. Increases in market interest rates;
- d. Company stock price is below book value;
- e. Obsolescence or physical damage;
- f. Asset is part of a restructuring or held for disposal;
- g. Economic performance of an asset is worse than expected.

12. In addition, an indication that an asset may be impaired may indicate that the asset's remaining useful life, depreciation method, or residual value may need to be reviewed and adjusted, even if no impairment loss is recognized for the asset.

Measurement

13. Recoverable amount is the higher of an asset's fair value less costs to sell and its value in use.

14. The best evidence of an asset's fair value less costs to sell is a price in an arm's length binding sale agreement. If there is no binding sale agreement but an asset is traded in an active market, the market price less costs of disposal is used. Market price means current bid price if available, otherwise it is the price in the most recent transaction. If there is no active market, the best estimate of the asset's selling price less costs of disposal is used.

15. The calculation of value in use should reflect the following elements:

- a. An estimate of the future cash flows the entity expects to derive from the asset in an arm's length transaction;
- 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; 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.

16. Cash flow projections should be based on reasonable and supportable assumptions, the most recent budgets and forecasts, and extrapolated for periods beyond budgeted projections. Cash flow projections should also 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 anticipated.

17. In measuring value in use, the discount rate used should be the rate that reflects current market assessments of the time value of money and the risks specific to the asset. If a market-determined asset-specific rate is not available, a surrogate must be used that reflects the time value of money over the asset's life as well as country risk, currency risk, price risk, and cash flow risk. The entity's own weighted average cost of capital is one such surrogate that would be considered.

Recognition

18. An impairment loss should be recognized whenever recoverable amount falls below carrying amount.

19. The impairment loss shall be recognized as an expense in profit or loss, unless it relates to a revalued asset when it shall be recognized against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount in the revaluation surplus for that same asset.

20. After the recognition of an impairment loss, the depreciation 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.

Cash-generating units

21. 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. Cash-generating units are the smallest identifiable group of assets that generate cash inflows and are largely independent of the cash inflows from other assets or groups of assets. Cash-generating assets are those that are held to generate a commercial return. The recoverable amount of an individual asset cannot be determined if the asset does not generate cash inflows that are largely independent of those from other assets. The implication is that the entity will be engaged in income-generating activity (through the provision of goods or services to external parties) to hold assets/units that are cash-generating. Entities should apply IAS 36 without adaptation to any income-generating activities.

Reversing an impairment loss

22. An entity shall assess at each reporting date whether there is any indication that an impairment loss recognized in prior periods may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset. Indications of a potential decrease in an impairment loss mirror the indications of a potential impairment loss in paragraph 11 above.

23. A reversal of an impairment loss shall be recognized immediately in profit and loss. The increased carrying amount due to reversal should be no more than the depreciated historical cost of an asset would have been if the impairment had not been recognized. A reversal of an impairment

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

24. After a reversal of an impairment loss is recognized, the depreciation 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.

Comparison with requirements under UK GAAP

25. The coverage of IAS 36 'Impairment of Assets' and FRS 11 'Impairment of Fixed Assets and Goodwill' is very similar, but there is an important difference between the two standards in the treatment of losses on revalued fixed assets.

26. Current accounting practice under FRS 11 requires losses (impairment) on revalued fixed assets to be charged to the profit and loss account if they are caused by a clear consumption of economic benefits. Other impairments of revalued fixed assets (i.e. those not caused by a consumption of economic benefits) should be recognized against any revaluation reserve for that asset until the carrying amount of the asset reaches its depreciated historical cost and thereafter in the profit and loss account. IAS 36 allows all losses to be set against previous revaluation gains before recognizing the loss in the income statement.

Disclosures in resource and other accounts

27. An entity shall disclose the following for each class of assets:

- a. Impairment losses recognized in profit or loss;
- b. Impairment losses reversed in profit or loss;
- c. The line item(s) of the profit or loss in which the impairment losses are recognized/reversed.

28. If an individual impairment loss/reversal is material disclose:

- a. Events and circumstances resulting in the impairment;
- b. Amount of the loss.

IAS/IFRS compliance - adaptation

29. The ASB has deferred any final decisions on convergence with IFRS until the outcome of the IASB project on SME. However, prior to this deferment by the ASB, the FRAB was invited to give its views on FRED 38 *Impairment of Assets* at its meeting of 28th September 2005. FRED 38 reflected the convergence agenda with IFRS. It proposed amendments to FRS 15 to bring it into line with IAS 36, including that an impairment loss that is caused by a clear consumption of economic benefits

would no longer be charged in full to the profit and loss, but would instead first be off-set against any revaluation reserve balance for that asset, and only then to the profit and loss.

30. The Board was invited to express its view on FRED 38's proposed amendments to FRS 15 for the reporting of revaluation gains and losses in respect of a weakening of the link between FREM based accounts and National Accounts; i.e. to adopt the amendments would open up a divergence between accounts and budgets, as the Treasury would not want to change the incentives structure in the budgetary framework to fit with the accounting proposal. **The same divergence exists if IAS 36 is adopted without adaptation, and accordingly an adaptation of IAS 36 to achieve consistency with the budgetary regime is contained in Annex A.**

31. The current budgetary framework assumes that impairments are charged in full to the operating cost statement as that provides the basis of the budgetary control totals. This treatment is part of the budgetary discipline that encourages departments to manage their assets more effectively. Where, as a result of management decisions or failure, an asset is consumed more quickly than previously thought then the department will suffer a cost in their budget to reflect that accelerated consumption of economic benefit. This budgetary treatment encourages the correct management incentives and protects the fiscal position as managed in the national accounts.

32. At the September 2005 meeting the Board expressed sympathy with the problems of not achieving consistency between the accounting and budgeting regimes. However, it was also noted that the Board should carefully consider any divergence from GAAP, and that divergences should only be agreed for two reasons; a significant budgetary issue or an issue that had National Accounts implications.

IPSAS compliance - interpretation

33. IPSAS 21 Impairment of Non-Cash-Generating Assets deals with the impairment of non-cash-generating assets in the public sector. The Standard is drawn primarily from IAS 36 and is consistent with it. The **interpretation** of IAS 36 for the public sector context in Annex A is in line with IPSAS 21 in that the value in use of a non-cash-generating asset should be measured by reference to the present value of the remaining service potential of the asset.

34. The PSASB issued exposure draft ED 30 Impairment of Cash-generating Assets in October 2006. This deals with cash-generating assets held and operated by public sector entities. The proposals in the exposure draft are similar to the requirements in IAS 36. Revalued items of property, plant and equipment are outside the scope of ED 30. IPSAS 17 Property Plant and Equipment (which applies to revalued assets) states that IAS 36 will apply in dealing with impairment of assets.

Proposed text for the IFRS-based Government Financial Reporting Manual

35. See Annex A for the proposed text to the IFRS-based FReM.

Impact on the budgetary regime

36. An adaptation of IAS 36 to achieve consistency with the budgetary regime is proposed.

Summary and recommendation

37. The objective of IAS 36 is to ensure that assets are carried at no more than their recoverable amount, and to define how recoverable amount is calculated. It is interpreted for the public sector context so that where an asset is not held for the purpose of generating cash flows, value in use should be assumed to be equal to the cost of replacing the service potential provided by the asset. It is adapted for the public sector context to achieve consistency with the budgetary regime.

HM Treasury
12 February 2007

PROPOSED TEXT FOR THE IFRS-BASED GOVERNMENT FINANCIAL REPORTING MANUAL

IAS 36 Impairment of Assets

Applicability

IAS 36 applies as adapted and interpreted.

Objectives of IAS 36

The objective of IAS 36 Impairment of Assets is to ensure that assets are carried at no more than their recoverable amount. 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 the Standard requires the recognition of an impairment loss.

Interpretation of IAS 36 for the public sector context

The following interpretations of IAS 36 for the public sector context apply.

Recognition and measurement

Where an asset is not held for the purpose of generating cash flows, value in use should be assumed to be equal to the cost of replacing the service potential provided by the asset, unless there has been a reduction in service potential.

Adaptation of IAS 36 for the public sector context

The following adaptations of IAS 36 for the public sector context apply.

Recognition and measurement

- a) A reduction in service potential might arise for various reasons, including:
- i) The purpose for which the asset was acquired is no longer carried out and there is no alternative use for the asset;
 - ii) The asset is to be sold;
 - iii) The asset cannot be used;
 - iv) The asset is otherwise surplus and has no alternative use; or
 - v) The asset is over-specified for its current use (for example, a hardened aircraft hangar used as a store).

- b) Where IAS 36 applies to a revalued asset, the loss should be recognized in the operating cost statement if it is caused by a clear consumption of economic benefits. This is to ensure that the correct incentives are brought to bear on managers of public sector assets i.e. where a loss is a result of management action or inaction then the full loss should be borne in operating cost, and not off-set by previous market-driven revaluation gains outside of management control.

Other relevant factors

In budgetary terms, certain impairments will score as DEL and others as AME, and departments will enter the type of impairment onto COINS using the relevant account code. The Consolidated Budgeting Guidance contains more detail. Entities might wish to consider whether information about the type and cause of the impairment could usefully be included in the relevant notes to the accounts. Impairment categories, which are defined in separate guidance on this Manual's website, are:

Loss or damage resulting from normal business operations (DEL)

Loss as the result of a catastrophe (AME)

Abandonment of assets in the course of construction (DEL)

Unforeseen obsolescence (AME)

Over specification of assets (gold plating) (DEL)

Other impairments (AME)