

# A86045 Accounting and Financial Reporting (2017/2018)

## Session 11 Impairment of Assets

# SESSION 11 OVERVIEW AND OBJECTIVES

# Course Overview

1. Financial reporting under IFRS	14. Construction contracts	
2. Financial analysis: Ratio analysis	15. Other Non-financial liabilities	
3. Financial analysis: Segments and EPS	16. Review session	
4. Review session	17. Mid term test	PGS
5. Revenues	18. Financial Instruments 1	
6. Costs and expenses	19. Financial Instruments 2	
7. Taxation - Direct and Indirect	20. Review session	
8. Non-current assets - Intangible assets	21. Cash Flow Statement	
9. Non-current assets - Tangible assets	22. Group accounts/Business comb	
10. Financial leases	23. Review session	PT
11. Impairment of assets	24. Review session	
12. Review session	25. Final test	PGS
13. Inventories		PT

# Objectives of Session

*At the end of this session students will be able to:*

1. Explain when an **impairment test** is required
2. Perform a simple impairment test using both **Fair Value Less Costs of Disposal (FVLCD)** and **Value in Use (VIU)**
3. Understand what **Cash Generating Units (CGUs)** are and why and how Goodwill is allocated to these.
4. Articulate the rules relating the **reversal** of impairment losses once recorded.

# Overview of Session 11

- Impairment of assets
  - Definition and rules
  - Identification of potential impairments
  - Measuring the recoverable amount
    - Fair value less cost of disposal (FVLCD)
    - Value in use (VIU)
  - Recognition and measurement
  - Cash-generating units and goodwill
  - Reversal of impairment losses
  - Some group issues

# Session 11 Overview

	Mins
Session overview and objectives	5
Review of pre-work and session 10 recap	5
What is impairment and when is testing required?	10
Fair Value vs. Value in Use (VIU)	10
VIU - Goodwill and Cash Generating Units (CGUs) - examples	15
Operating Segments and CGUs - Examples	5
Worked example of Value in Use Computation	5
Research Assignment RA 9 – Impairment testing	15
Reversal of impairment losses	5
Some Group issues	5
Class exercise/some examples	-
Overview of session 12, required reading and assignment	5
Summary and validation	<u>5</u>
	90

# SESSIONS 10 RECAP AND PRE- WORK SESSION 11

# Recap of Session 10

- Leasing (IAS 17)
  - Finance or operating
  - Lessee vs. lessor accounting
  - Sale and leaseback transactions
  - Disclosures
- Leasing (IFRS 16)
  - The need for change
  - Changes in Lessee vs. lessor accounting
  - Impact on Performance metrics
  - Effective date and transition



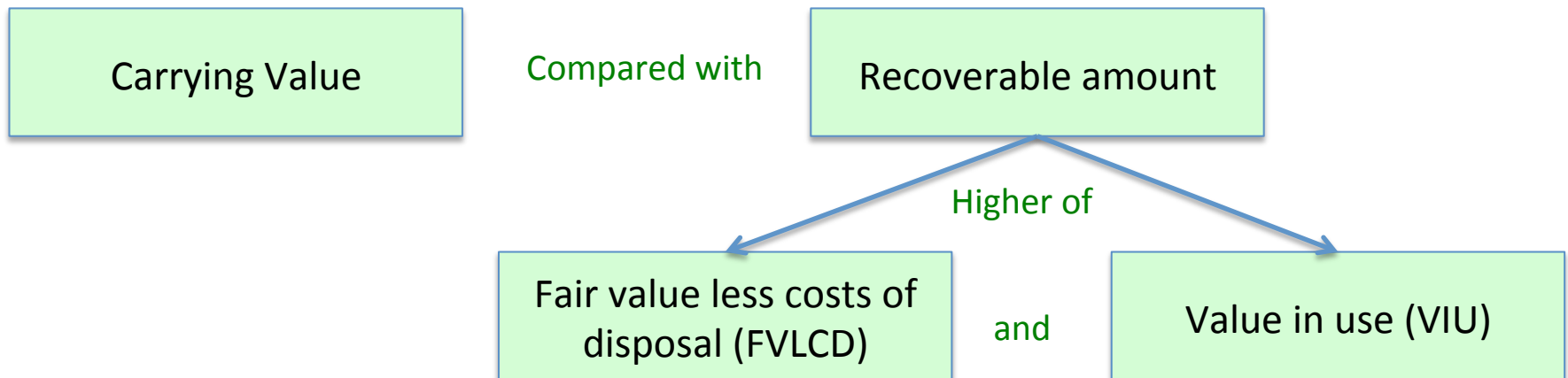
# Session 11 Pre-work

- Reading
  - Melville International Financial Reporting
    - Chapter 9 – Leases
  - IASB Statements
    - IAS 17 Leases
    - IFRS 16 Leases
- Exercises
  - Melville On-line multiple choice questions for Chapter 9
  - Melville Exercises 9.1 – 9.8
  - EX 10 Leases- Exercises
- Research assignment
  - RA 9 Identify how your chosen company performs reviews for the impairment of its assets .

# **WHAT IS IMPAIRMENT? WHEN IS TESTING REQUIRED?**

# Impairment- Definition

*Impairment.* An asset is impaired when an entity will not be able to recover that asset's balance sheet carrying value, either through using it or by selling it.



In what situations might this arise?

Not always necessary to do both if one is higher than the carrying amount.

# When is an impairment test required?

For **Goodwill**, all assets with an **indefinite life** and intangibles that have **not yet been brought into use** (greatest uncertainty)



Test annually, but at any time in the year.

For **all other** classes of assets within the scope of IAS 36



At each balance sheet date an **assessment** as to whether impairment indicators exist

Yes

No

Test

Test not required

# Indicators of impairment

## External sources of information:

- a) A decline in an asset's value during the period that is significantly more than would be expected from normal use;
- b) Significant adverse changes that 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 in which an asset is dedicated;
- c) An increase in the period in market interest rates or other market rates of return on investments if these 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 exceeds its market capitalization.

## Internal sources of information:

- a) Evidence of obsolescence or physical damage of an asset;
- b) Significant changes in ten extent to which, or manner in which, an asset is used or is expected to be used, that have taken place in the period or soon thereafter and that will have an adverse effect on it. These changes include the asset becoming idle, plans to dispose of an asset sooner than expected, reassessing its useful life as finite rather than indefinite or plans to restructure the operation to which the asset belongs;
- c) Internal reports that indicates that the economic performance of an asset is, or will be, worse than expected.
  - I. Cash flows for acquiring or operating higher than originally budgeted;
  - II. Operating profit or loss or net cash flows significantly less than budgeted;
  - III. Significant decline in budgeted net cash flow; or
  - IV. Operating losses or net cash outflows for the asset if current periods added to budgeted amounts

***N.B. Changes in market interest rates can have a significant impact on value in use calculations***

# FAIR VALUE VS. VALUE IN USE (VIU)

# Fair Value vs. Value in use

## Fair value

- IFRS 13 focus on types of inputs to be used maximizing observable and minimizing unobservable input.
  - Market approach
  - Cost approach
  - Income approach

*If possible, recoverable amount is calculated for individual assets. However, it is frequently necessary to do this for the Cash Generating Unit (CGU) of which the asset is part if the asset does not generate sufficiently independent cash flows.*

## Value in use

- Requires determination of:
  - Estimated future cash flows;
  - The time value of money;
  - The price for bearing the uncertainty inherent in the asset; and
  - Other factors such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset

# Fair value less costs of disposal (FVLCD)

SM 11.1

IFRS 13 Definition of Fair Value:

*The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. **An exit price.***

**Market approach:** prices from market transactions for identical or similar transactions i.e. multiples

**Cost approach:** the amount required to replace the service capacity of the asset

**Income approach:** converts future amounts (cash flow, income and expenses to a single discounted amount

No attempt to limit the type of valuation technique. Instead focuses on the types of inputs that will be used. Requires use of techniques that maximize the use of observable inputs and minimizes the use of unobservable inputs



# VALUE IN USE - GOODWILL AND CASH GENERATING UNITS - EXAMPLES

# Goodwill and Cash Generating Units (CGUs)

A **Cash Generating Unit** (CGU) 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.

If an asset has no individually identifiable cash flows, the entity will need to be divided into Cash Generating Units (CGUs). This should not go beyond the level at which each income stream is *capable* of being separately monitored. Consider:

- Newspaper mast-heads
- Retail outlets
- Tour operator's hotels
- Flagship stores

CS 11.2  
Additional  
examples

*Goodwill cannot be tested for impairment alone as it does not generate cash flows independently of other assets. It therefore has to be allocated to a cash-generating unit (CGU) or group of CGUs. No allocation guidance is provided. N.B. This can't be larger than a segment as defined in IFRS 8*

# CGU example - Newspapers

## Background

An entity publishes 10 suburban newspapers, each with a different mast-head, across 4 distinct regions within a major city. The price paid for a purchased mast-head is recognized as an intangible asset. The newspapers are distributed to residents free of charge. No newspaper is distributed outside its region. All of the revenues generated by each newspaper comes from advertising sales. An analysis of advertising sales shows that for each mast-head:

- Approximately 90% of sales comes from advertisers purchasing “bundled” advertisements that appear in all those newspapers published in one particular region of the city;
- Approximately 6% of sales comes from advertisers purchasing “bundled” advertisements that appear in all 10 newspapers in the major city; and
- Approximately 4% of sales come from advertisers purchasing advertisements that appear in one newspaper only.

***What is the cash-generating unit for an individual mast-head?***

# CGU example - Newspapers

## Considerations

*Stage 1: Identify the smallest aggregation of assets for which a stream of cash inflows can be identified.*

The fact that it is possible to use a pro-rate allocation basis to determine cash inflows attributable to each newspaper means that each mast-head is likely to represent the smallest aggregation of assets for which a stream of cash inflows can be identified.

*Stage 2: Are the cash inflows generated by an individual mast-head largely independent of those of other mast-heads and, conversely, is that individual mast-head affecting the cash inflows generated by other mast-heads?*

As approximately 96% of cash inflows for each mast-head arise from “bundled” advertising sales across multiple mast-heads, the cash flows generated by an individual mast-head are not largely independent.

Therefore, the individual mast-heads would most likely be aggregated to form the smallest collection of assets that generates largely independent cash inflows. On the basis that approximately 90% of cash inflows for each mast-head arise from “bundled” advertising sales across all of the newspapers published in a particular region, it is likely that those mast-heads published in one region will together form a cash-generating unit.

# CGU example - Retail outlets

## Background

An entity has a chain of retail outlets located in the same country. The business model of the entity is highly integrated and the majority of the entity's revenue generating decisions, such as decisions about investments and monitoring of performance, are carried out at an entity level by the executive committee, with some decisions (such as product range and marketing) delegated to the regional or store levels. The majority of the operations, such as purchasing, are centralized. Management operates its business on a regional basis; but sales are monitored at the individual store level.

The outlets are usually bought and sold in packages of outlets that are subject to common economic characteristics e.g. outlets of similar size or location such as shopping center or city or region. Only in rare situations has the entity sold or closed down an individual outlet.

# CGU example - Retail outlets

## Considerations

The determining factor for CGUs is the level at which largely independent cash inflows are generated, and not the manner in which the entity's operations are organized and monitored. The fact that the operations and costs are managed centrally does not of itself affect the source and independence of the cash inflows. The interdependence of cash outflows is unlikely to be relevant to the interdependence of CGUs.

The key issue in deciding whether CGUs should be identified at the level of the individual store as opposed to a group of stores is whether, if a store is closed down, all the customers of that store would seek out another of the entity's stores such that there is no overall "leakage" of custom from store closure. In the highly likely event that all the customers would not do this, the individual stores are separate CGUs.

# CGU example - A tour operator's hotels

## Background

A tour operator owns three hotels of a similar class near the beach at a large holiday resort. These hotels are advertised as alternatives in the operator's brochure, at the same price. Holidaymakers are frequently transferred from one to another and there is a central booking system for independent travellers.

## Considerations

In this case it may be that the hotels can be regarded as offering genuinely substitutable products by a sufficiently high proportion of potential guests and can be grouped together as a single cash-generating unit. Effectively, the hotels are being run as a single hotel on three sites. The entity will have to bear in mind that disposal decisions may still be made on a hotel-by-hotel basis and have to weight this appropriately in its determination of its CGUs

# CGU example - Flagship stores

## Background

Store Z is a flagship store located in a prime location in a capital city. Although store Z is loss making, its commercial performance is in line with expectations and with budgets.

*How should the impairment issues of the flagship store Z be considered?*



# CGU example - Flagship stores

## Considerations

It is difficult to conclude that a flagship store is a corporate asset. It may be possible to argue for the aggregation of the flagship store with others in the vicinity into a single CGU as flagship stores are usually designed to enhance the image of the brand and hence other stores as well. They may be budgeted to run with negative cash flows; perhaps in substance the losses are not an impairment.

However, this argument for not recognizing an impairment would generally only be acceptable during a start-up phase and it must be borne in mind that the added function the flagship store is largely marketing. As marketing expenditures are expensed, it would not necessarily be inconsistent to take an impairment loss and the entity may have to consider whether it should have capitalized these costs in the first place.

See also Wiley Chapter 9

# **OPERATING SEGMENTS (IFRS 8) AND CGUS - EXAMPLES**

# Operating segments

*Core principle: An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environment in which it operates.*

*The IFRS requires an entity to report financial information about its “Reportable Segments”*

*Reportable segments are operating segments or aggregations of operating segments that meet specified criteria. Operating segments are components of an entity about which separate financial information is available that is regularly evaluated by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Generally financial information is required to be reported on the same basis as is used internally for evaluating operating segment performance and deciding how to allocate resources to operating segments.*

*The IFRS requires an entity to report information about the revenues derived from its products or services (or groups of similar products and services, about the countries in which it earns its revenues and holds assets, and about major customers, regardless of whether this information is used by management in making operating decisions.*

*The IFRS also requires an entity to give descriptive information about the way the operating segments were determined, the products and services provided by the segments, differences between the measurements used in reporting segment information and this used in the entity’s financial statements and changes in the measurement of segment amounts from period to period.*

# Example - Unilever

Revenues		NL/UK	USA	Brazil	Others	Total
		3,980	7,834	3,813	35,697	51,324
Segments	Personal care					18,097
	Foods	GW 5,8 ILI 1,6	GW 3,9 ILI 1,4	GW 1,4 ILI 0,4		14,444
	Refreshment					9,726
	Home care					9,057
		13,879	17,088	20,357		51,234
		Europe	The Americas	Asia/ AMET/RUB		
Cash-Generating Units						

GW = Goodwill  
ILI = Indefinite lived intangibles

# Example - Nestlé

	Sales Millions CHF	Europe	Americas	Asia, Oceania, Africa	Nestlé Waters	Nestlé Nutrition	Other	Total							
		15,385	28,927	18,912	7,174	7,858	13,930	92,186							
Products	Powdered and liquid beverages		<p>Goodwill impairment reviews have been conducted for more than 200 goodwill items allocated to some 50 Cash Generating Units (CGU).</p>						20,038						
	Water										7,178				
	Milk products and ice cream										18,564				
	Nutrition and health care										10,726				
	Prepared dishes and cooking aids						<p>Detailed results of the impairment tests are presented below for the four largest goodwill items, representing more than 50% of the net book value at 31 December 2012. For the purpose of the tests, they have been allocated to the following CGU: Wyeth Nutrition (WN), PetCare by geographical zone, Infant Nutrition excluding WN (IN), Frozen Pizza and Ice Cream USA.</p>						14,432		
	Confectionery														10,438
	PetCare														10,810

# Example -ABInBev

Revenues (Million US\$)

Geographical segments

North America	Latin America North	Latin America South	Western Europe	Central and Eastern Europe	Asia Pacific	Global Export	Total	
16,028	11,455	3,024	3,625	1,668	2,690	1,270	39,758	

The carrying amount of goodwill and intangibles with indefinite useful lives was allocated to the different business unit levels/countries as follows:

	Goodwill	Indefinite lived Intangibles
USA	32,64	21,340
Brazil	8,743	3
Canada	2,078	40
China	1,925	280
Germany/Italy/Switzerland/Austria	1,469	Germany 19
Hispanic Latin America	1,345	Argentina 292, Paraguay 201, Bolivia 171, Uruguay 52, Chile 26
Dominican Republic	1,089	425
Russia/Ukraine	1,057	Russia 27
Global Export/Spain	698	
UK/Ireland	609	UK 108
Belgium/Netherlands/France/Luxembourg	<u>99</u>	
	51,766	22,984

# Example - Diageo

For goodwill the recoverable amount is calculated in respect of the cash-generating unit including the attributed goodwill.

Cash flows are forecast for each brand, other intangible and cash-generating unit

Segments	Sales	Goodwill attribution
North America	4,272	209
Western Europe	3,686	174
Africa, E Europe, Turkey	3,423	761
Latin America, Caribbean	1,745	74
Asia Pacific	2,285	122
Global Supply	2,648	
Eliminations	(2,648)	
Corporate/ other	76	37
<b>Total</b>	<b>15,487</b>	<b>1,377</b>

## Carrying amount of acquired brands

	Principal markets	£ millions
Crown Royal whisky	United States	963
Captain Morgan	Global	790
Johnnie Walker whisky	Global	625
Yeni Raki	Turkey	580
Shui Jing Fang Chinese white spirit	Greater China	536
Smirnoff vodka	Global	542
Windsor Premier whisky	Korea	499
Bell's whisky	South Africa	179
Ypióca cachaça	Brazil	135
Bushmills whiskey	United States	144
Seagram's 7 Crown whiskey	United States	147
Zacapa rum	Global	126
Seagram's VO whiskey	United States	125
Gordon's gin	Great Britain	119
Old Parr whisky	Venezuela	99
Bundaberg rum	Australia	81
Tanqueray gin	United States	78
Cacique rum	Spain	68
Romana Sambuca liqueur	United States	57
White Horse whisky	Russia	53
Meta beer	Ethiopia	51
Other brands		247
		<b>6,244</b>

# Example - LVMH

## Revenues by Business Group (€ millions)

Wines and Spirits	Fashion and Leather	Perfumes and Cosmetics	Watches and Jewelry	Selective Retailing	Other	Total
4,116	9,872	3,165	2,778	7,856	316	28,103

## Brands and Trade Names by Business Group (€ millions)

Wines and Spirits	Fashion and Leather	Perfumes and Cosmetics	Watches and Jewelry	Selective Retailing	Other	Total
973	3,532	596	3,528	2,049	195	10,828

## Most significant intangibles with indefinite useful lives (€ millions)

	Brands and Trade names	Goodwill	Total	Post-tax Discount rate %	Growth rate after plan %	Cash flow forecast period Yrs
Louis Vuitton	2,058	494	2,552	8,0	2	5
Fendi	713	405	1,118	9,6	2	5
Bulgari	2,100	1,523	3,623	9,2	2	10
TAG Heuer	1,027	196	1,223	9,2	2	5
DFS Galleria	1,734	15	1,749	9,6	2	5
Sephora	279	615	894	8,4	2	5



# VALUE IN USE EXAMPLE

# Value in use (VIU) - example

(Illustrative purposes only)

Assume a wholly-owned subsidiary is a CGU.

- The carrying amount of the CGU is CU 9,500 including allocated goodwill pertaining to synergetic cost savings arising from the parent's bulk purchasing power.
- The industry to which the CGU belongs is experiencing mid to high level growth (6-14%) and market participants are forecasting future capacity shortage in the medium term. In the long-term, industry growth of 1% is expected.
- Management has no plan to expand the capacity of the CGU and believes a reorganization may achieve cost savings, but has not yet committed to a plan.
- Management determines the recoverable amount of the CGU at 31 December 2010 based on a VIU approach.
- The pre-tax discount rate is assumed at 12.5%.

Based on the VIU determined on the next slide, the CGU has an impairment loss of CU 468 (9,032 – 9,500).

Since VIU is lower than the carrying amount for the CGU, management would calculate the FVLCS, the higher of the two would be the recoverable amount of the CGU. See FVLCD example.

# Value in use (VIU) -example

	2011	2012	2013	2014	2015
Revenue	3,500	3,710	3,933	4,169	4,419
Revenue growth per approved budget	6%	6%	6%	6%	6%
EBITDA	1,050	1,113	1,180	1,251	1,326
EBITDA Margin per approved budget	30%	30%	30%	30%	30%
Add: Change in net working capital	(12)	(11)	(11)	(12)	(13)
Less: Replacement cash expenditure	(175)	(195)	(270)	(325)	(250)
Pre-tax Free cash flow	863	907	899	914	1,063
Discount rate (pre-tax rate based on WACC)	12,5%				
Discount period (mid-year convention)	0,5	1,5	2,5	3,5	4,5
Discount factor	0,943	0,838	0,745	0,662	0,589
Present value free cash flow	814	760	670	605	626
Present value of free cash flow (FY11 to FY15)	3,475				
Present value of terminal value	5,557				
Value in use	9,032				

# Value in use (VIU) example

Notes:

EBITDA can be used as a substitute in the projection of income and expense related cash flows. However, adjustments need to be made to account for other cash flows not captured within EBITDA, including working capital movements and capital expenditure.

As required by IAS 36, cash flow projections for periods beyond the most recent budgets/forecasts are determined by extrapolation using a steady or declining growth rate, unless an increasing growth rate can be justified. The resulting figure is called the terminal value. It is then discounted to present value.

To calculate the terminal value in this example, we

- Calculated the normalized future long-term cash flow of CU 1,074 – determined by using the 2015 pre-tax cash flow of CU1,063 and adjusting it for a lower change on working capital due to a lower long-term growth rate.
- Applied the long-term annual growth rate of 1% to the normalized future cash flows to determine the terminal value.
- Discounted the terminal value using the assumed pre-tax discount rate of 12.5% and the discount factor used in 2015 of 0,589. That is  $CU\ 5,557 = (1,074 * 1,01) / (12,5\% - 1\%) * 0,589$

# Discount rate

*A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset.*

As a starting point the entity might take into account:

- Its weighted-average-cost-of-capital (WACC)
- The entity's incremental borrowing rate
- Other market borrowing rates

A pre-tax rate is required. Therefore if a post-tax basis is used e.g. WACC it will need to be adjusted to reflect a pre-tax rate.

# Weighted-average-cost-of-capital

$$WACC = (1 - t) \times D \times \frac{g}{(1 + g)} + E \times 1 - \left[ \frac{g}{(1 + g)} \right]$$

T = tax rate

D is the pre-tax cost of debt

E is the cost of equity

G is the gearing level for the sector

Cost of equity = risk-free factor + (levered beta (B\*) x market risk premium

\* [Capital Asset Pricing Model \(CAPM\)](#) is frequently used. Various bodies such as the London Business School publish betas on a regular basis.

The **pre-tax rate** can be obtained by grossing up the post-tax rate as follows:  $1/(1-t)$  where t is the tax rate.

i.e.  $9.3 / 0.75 = 12.4\%$

Cost of equity*	
risk free rate	4%
levered beta (B)	1.1%
Market risk premium	6%
Cost of equity after tax (market risk premium x B + risk-free rate)	10.6%

Cost of debt	
risk free rate	4%
Credit spread	3%
Cost of debt (pre-tax)	7%
Cost of debt (post-tax)	5.25%

Capital structure	
Debt / (debt + equity)	25%
Equity / (debt + equity)	75%
Tax rate	25%
Post-tax cost of equity (10.6 x 75%)	8%
Post-tax cost of debt (5.25 x 25%)	1.3%

WACC (Post-tax nominal) 9.3%  
(8% + 1,3%)

# FVLCD Example

*Considering the previous example. Since VIU is lower than the carrying amount for the CGU, management would calculate the FVLCD.*

If management calculated FVLCD using a DCF approach, the following differences would, for example, apply to the calculation.

- Market participants would estimate the fair value considering the effects of **restructuring and increasing capacity**. These activities will decrease the free cash flows in the short-term, but will ultimately result in higher growth in revenues and increased cash flows.
- The estimated revenue margins in a FVLCD calculation would not include **synergistic savings** since these synergies would not be available to most market participants.
- The **discount rate** applied to the calculation would be based on what a normal market participant would consider.

# RESEARCH ASSIGNMENT RA9 IMPAIRMENT



# Research assignment RA 9

## Impairment Testing

Company\_\_\_\_\_

Accounting policies/principles

Impairment tests: Goodwill and other intangibles

Impairment tests: Property, plant and equipment

# ACCOUNTING FOR AND REVERSAL OF IMPAIRMENT LOSSES

# Accounting for Impairment losses

If, following the impairment test, the **Recoverable Amount** is less than the **Carrying Amount** then:

**Individual asset** – the difference is expensed in the profit and loss account or debited to the revaluation reserve depending on whether the asset is valued at cost or revaluation.

**CGU** – the difference is first allocated to reduce goodwill until this is eliminated and, only then, to individual assets.

# Reversal of Impairment losses

Goodwill	<b>Not Allowed</b>
Other Assets	<b>Allowed</b>

# SOME GROUP ISSUES

# Some Group issues

- Transfer pricing – Re-state at fair value
- Standalone financial statements – Dividend Discount Model (DDM) rejected
- Associates and Joint ventures – Similar PPAs and considerations apply as for subsidiaries

# DISCLOSURES

# IAS36 disclosure requirements

For each class of assets, the entity should disclose:

- the amount of impairment losses (or reversals) recognised as expenses (or income) during the period and the line items in which these are included;
- the amount of impairment losses (or reversals) recognised in other comprehensive income during the period.

For each material impairment loss or reversal recognised in the period, the entity should make various disclosures with regard to the nature, amount and circumstances of the loss or the reversal.



Source IAS 36 Illustrative Examples

# CLASS EXERCISE/EXAMPLES

# Impairment examples - 1

## A - Retail store chain

### Background

Store X belongs to retail store chain M. X makes all its retail purchases through M's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring X's cashiers and sales staff) are decided by M. M also owns five other stores in the same city as X (although in different neighbourhoods) and 20 other stores in other cities. All stores are managed in the same way as X. X and four other stores were purchased five years ago and goodwill was recognized.

What is the cash-generating unit for X (X's cash-generating unit)?

# Impairment examples - 1

## Analysis

In identifying X's cash-generating unit, an entity considers whether, for example:

- a) Internal management reporting is organized to measure performance on a store-by-store basis; and
- b) The business is run on a store-by-store basis or on a region/city basis.

All M's stores are in different neighbourhoods and probably have different customer bases. So, although X is managed at a corporate level, X generates cash inflows that are largely independent of those of M's other stores. Therefore it is likely that X is a cash generating unit.

If X's cash-generating-unit represents the lowest level at which the goodwill is monitored for internal management purposes, M applies to that cash-generating-unit the impairment test described in paragraph 90 of IAS 36 (annual test). If information about the carrying amount of goodwill is not available and monitored for internal management purposes at the level of X's cash-generating unit, M applies to that cash-generating unit the impairment test described in paragraph 88 of IAS 36 (test if there is an indication of impairment).

# Impairment examples - 2

## B - Plant for an intermediate step in a production process

### Background

A significant raw material used for plant Y's final production is an intermediate product bought from plant X of the same entity. X's products are sold to Y at a transfer price that passes all the margins to X. Eighty per cent of Y's final production is sold to customers outside of the entity. Sixty per cent of X's final production is sold to Y and the remaining 40 per cent is sold to customers outside of the entity.

For each of the following cases, what are the cash-generating units for X and Y?

**Case 1:** X could sell the product it sells to Y in an active market. Internal transfer prices are higher than market prices.

**Case 2:** There is no active market for the products that X sells to Y.

# Impairment examples - 2

## Analysis

### Case 1

X could sell its products in an active market and, so, generate cash inflows that would be largely independent of the cash flows from Y. Therefore, it is likely that X is a separate cash-generating unit, although part of its production is used by Y. (see paragraph 70 of IAS 36).

It is likely that Y is also a separate cash-generating-unit. Y sells 80 per cent of its products to customers outside of the entity. Therefore, its cash inflows can be regarded as largely independent.

Internal transfer prices do not reflect market prices for X's output. Therefore in determining value in use of both X and Y, the entity adjusts financial budget/forecasts to reflect management's best estimate of future prices that could be achieved in arm's length transactions for those of X's products that are used internally (see paragraph 70 of IAS 36).

# Impairment examples - 2

## Analysis

### Case 2

It is likely that the recoverable amount of each plant cannot be assessed independently of the recoverable amount of the other plant because:

- a) The majority of X's production is used internally and could not be sold in an active market. So, cash inflows of X depend on demand for Y's products. Therefore, X cannot be considered to generate cash inflows that are largely independent of those of Y.
- b) The two plants are managed together

As a consequence, it is likely that X and Y together are the smallest group of assets that generates cash inflows that are largely independent.

# Impairment examples - 3

## C – Single product entity

### Background

Entity M produces a single product and owns plants A, B and C. Each plant is located in a different continent. A produces a component that is assembled in either B or C. The combined capacity of B and C is not fully utilized. M's product are sold worldwide from either B or C. For example, B's own production can be sold in C's continent if the products can be delivered faster from B than C. Utilization levels of B and C depends on the allocation of sales between the two sites.

For each of the following cases, what are the cash-generating-units for A, B and C?

Case 1: There is an active market for A's products.

Case 2: There is no active market for A's products.

# Impairment examples - 3

## Analysis

### Case 1

It is likely that A is a separate cash-generating-unit because there is an active market for its products.

Although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for B and C can be determined individually. Therefore, it is likely that B and C together are the smallest identifiable group of assets that generates cash inflows that are largely independent.

In determining the value in use of A and B plus C, M adjusts financial budgets/forecasts to reflect the best estimate of future prices that could be achieved in arm's length transactions for A's products.



# Impairment examples - 3

## Analysis

### Case 2

It is likely that the recoverable amount of each plant cannot be assessed independently because:

- a) There is no active market for A's products. Therefore A's cash inflows depend on sales of the final product by B and C.
- b) Although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash flows for B and C can be determined individually.

As a consequence, it is likely that A, B and C together (i.e. M as a whole) are the smallest identifiable group of assets that generates cash inflows that are largely independent.

# Impairment examples - 4

## D – Magazine titles

### Background

A publisher owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognized as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognized as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of the titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment.

What is the cash-generating-unit for an individual magazine title?

# Impairment examples - 4

## Analysis

It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis.

Therefore it is likely that individual magazine titles generate cash inflows that are largely independent of each other and that each magazine title is a separate cash-generating-unit.

# Impairment examples - 5

## **E – Building half-rented to others and half-occupied for own use**

### Background

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

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

# Impairment examples - 5

## Analysis

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

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

# Impairment examples - 6

See [CS 8.1 Impairment of assets on website](#). This is an example of how to calculate value in use, recognition and measurement of an impairment loss.

# **OVERVIEW, REQUIRED READING AND ASSIGNMENT FOR NEXT SESSION**

# Overview of Session 12

- Review session
  - Revenues
  - Costs and expenses (including pensions and share-based payments)
  - Taxation (Direct and Indirect)
  - Non-current assets (Intangible, Tangible)
  - Leases
  - Impairment of assets



# Session 12 Pre-work

- Reading
  - Melville International Financial Reporting
    - Chapter 7 – Impairment of assets
  - IASB Statements
    - IAS 36 Impairment of Assets
    - IFRS 8 Operating Segments
- Exercises
  - Melville On-line multiple choice questions for Chapter 7
  - Melville Exercises 7.1 – 7.8
  - EX 11 Impairment of Assets- Exercises
- Research assignment
  - None

# Session 12 Review Session Pre-work

- **Required reading/review**

- **Melville International Financial Reporting A Practical Guide:**

- Chapter 13 – Revenues
    - Chapter 14 – Employee benefits
    - Chapter 15 – Taxation
    - Chapter 6 – Intangible assets
    - Chapter 5 Property, plant and equipment
    - Chapter 9 Leases
    - Chapter 7 Impairment of assets

- **IASB Statements**

- IFRS 15 Revenues from contracts with customers
    - IFRS 2 Share-based payments
    - IAS 19 Employee benefits
    - IAS 12 Income taxes
    - IAS 38 Impairment of assets
    - IFRS 3 Business combinations

- **IASB Statements cont'd**

- IAS 16 Property, plant and equipment
    - IAS 23 Borrowing costs
    - IAS 40 Investment properties
    - IAS 17 Leases
    - IFRS 16 Leases
    - IAS 36 Impairment of assets

- **Exercises**

- Melville Exercises for these chapters
    - Melville on-line multiple choice questions
    - EX 5 – 11 Exercises

# SUMMARY AND VALIDATION

# Summary of Session 11

- Impairment of assets
  - Identification of potential impairments
  - Measuring the recoverable amount
    - Fair value less cost of disposal
    - Value in use
  - Recognition and measurement
  - Cash-generating units and goodwill
  - Reversal of impairment losses
  - Some group issues

# Session11 Validation

- How do we define impairment?
- What are the two ways of determining Recoverable Amount?
- What is a Cash-Generating-Unit (CGU)?
- Why do we need to allocate goodwill to CGUs?
- Can we reverse impairment losses?
- When do we need to test for impairment?