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Insights into MFRS 136

Recognising impairment losses

MFRS 136 'Impairment of Assets' specifies the accounting for impairment reviews. There are some detailed requirements of MFRS 136 that are complex and sometimes difficult to interpret and therefore are challenging to apply when preparing financial statements.

The articles in our 'Insights into MFRS 136' series have been written to assist preparers of financial statements and those charged with the governance of reporting entities understand the requirements set out in MFRS 136, and revisit some areas where confusion has been seen in practice.

Step 6 of applying the guidance in MFRS 136 as set out in our article '**Insights into MFRS 136 – Overview of the Standard**' and relates to recognising or reversing and impairment losses. This article focuses on part of this step; recognition of impairment losses. For reversing impairment losses refer to our article **'Insights into MFRS 136 - Reversing impairment losses'** which will be released later.

Step 6: Recognise or reverse any impairment loss

The requirements for recognising and measuring impairment losses differ based on the structure of the impairment testing as determined in Step 2 , discussed in our article '**Insights into MFRS 136 – Scope and structure of an impairment review**'. The requirements for recognising and measuring impairment losses for an individual asset (other than goodwill) are addressed in firstly below; and then the requirements for recognising and measuring impairment losses for cash-generating units (CGUs) and goodwill are addressed after that.

Recognising an impairment loss for an individual asset

When the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset needs to be reduced to its recoverable amount and that reduction is recognised as an impairment loss.

For assets accounted for using the revaluation model in MFRS 116 'Property, Plant and Equipment' or MFRS 138 'Intangible Assets', the impairment loss is treated in the same way as a downward revaluation in accordance with those standards. Accordingly any impairment is recognised in other comprehensive income to the extent it does not exceed a previous revaluation surplus. Any excess is recognised in profit or loss.

To the extent the amount estimated for an impairment loss exceeds the carrying amount of the asset to which it relates, an entity shall recognise a liability if, and only if, required by another standard.

Practical insight – Impairment loss exceeds the carrying amount of the asset to which it relates
An unallocated impairment loss for an individual asset (ie a loss exceeding the carrying amount of the asset in question) might arise if the asset is expected to generate negative net future cash flows – for example an asset that is nearing the end of its economic life and requires significant decommissioning or holding costs.

In such cases the value in use (VIU) estimate would be negative. In addition, the entity might need to pay potential buyers to acquire the asset in which case fair value less cost of disposal (FVLCOD) would also be negative. In these cases, the entity would not reduce the carrying value of the asset to less than zero. The entity would look to MFRS 137 'Provisions, Contingent Assets and Contingent Liabilities' to determine whether a provision for decommissioning costs must be recognised.

Finally, when an entity recognises an impairment loss for an individual asset, it must:

- adjust the future depreciation (amortisation) charge for the asset to allocate the asset's revised carrying amount, less its residual value (if any) on a systematic basis over its remaining useful life (see example 1 below), and
- determine any related deferred tax assets or liabilities in accordance with MFRS 112 'Income Taxes' by comparing the revised carrying amount of the asset with its tax base (see example 2 below).

Example 1 – Adjusting future depreciation of an asset after recognising an impairment

A machine was purchased on 1 January 20X1 by Entity A for CU300,000 with an estimated useful life of 3 years and no residual value; therefore, CU100,000 of depreciation expense was recognised on a straight-line basis for both 20X1 and 20X2 (or CU8,333 per month). At 31 December 20X2, management determines an impairment indicator exists and estimates the recoverable amount of the machine to be CU80,000 (carrying amount at 31 December 20X2 is CU100,000).

Analysis

Entity A recognises an impairment loss for the difference (CU100,000-CU80,000 or CU20,000). In accordance with MFRS 136, the entity also adjusts future depreciation of the machine after recording the impairment at 31 December 20X2 and will therefore recognise CU6,667 per month of depreciation from 1 January 20X3 – 31 December 20X3.

Example 2 – Determining any related deferred tax assets/liabilities after recognising an impairment

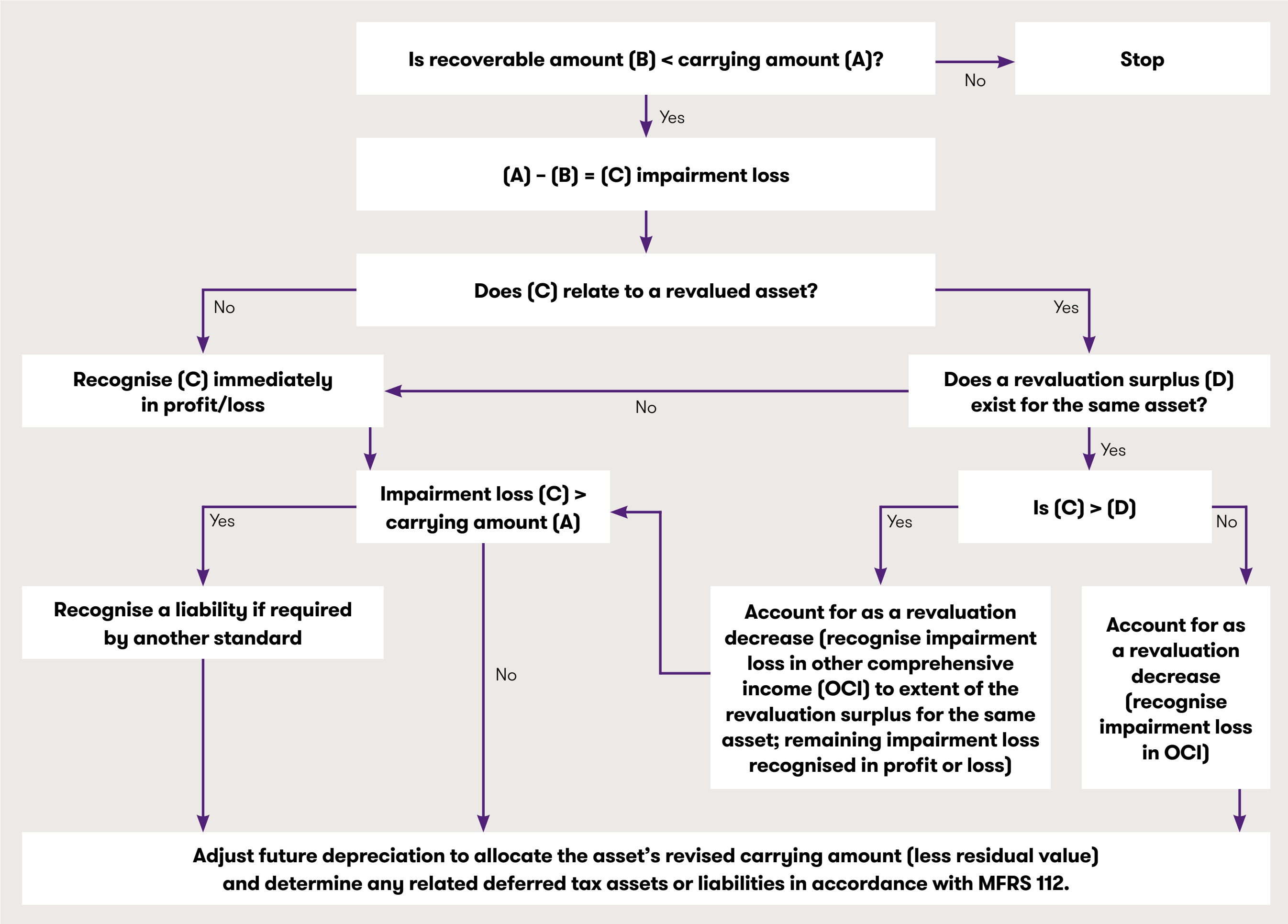
An entity owns a machine with a carrying amount of CU2,000. After finding evidence of an impairment indicator, management estimates the recoverable amount of the machine to be CU1,600. The entity records an impairment loss of CU400 (CU2,000 – CU1,600) for the machine. The tax rate is 35% and the tax base of the machine is CU1,800. Impairment losses are not deductible for tax purposes.

Analysis

The recognition of the impairment loss creates a deferred tax asset of CU70 as shown below, subject to meeting the criteria in MFRS 112 'Income Taxes' for recognition of deferred tax assets.

	Before Impairment	Effect of Impairment	After Impairment
Carrying amount	2,000	(400)	1,600
Tax base	1,800	–	1,800
Taxable (deductible) temporary difference	200	(400)	(200)
Deferred tax liability (asset) at 35%	70	(140)	(70)

The below diagram summarises MFRS 136's requirements for recording an impairment for an individual asset.



Recognising an impairment loss for CGUs

An impairment loss must be recognised for a CGU when the recoverable amount of the unit is less than its carrying amount. MFRS 136 prescribes the impairment loss to be allocated:

- first, to reduce the carrying amount of any goodwill allocated to the CGU
- then, to the other assets of the unit, pro rata on the basis of the carrying amount of each asset in the unit.

However, in allocating the impairment loss, an entity cannot reduce the carrying amount of an individual asset below the highest of:

- its FVLCOD (if measurable)
- its VIU (if determinable), and
- zero.

These amounts serve as a 'floor' as outlined in the below diagram.

If, for an individual asset within an impaired CGU, it is possible to measure FVLCOD but not VIU (and therefore not possible to determine the individual asset's recoverable amount), then the floor is the higher of FVLCOD and zero. Under this scenario no impairment loss is recognised for the individual asset if the asset's CGU is not impaired, even if the asset's FVLCOD is less than its carrying amount.

Should the 'floor' be applicable for an asset; any amount that would have been allocated to the individual asset must be allocated pro rata to the other assets of the unit. The reductions in carrying amounts from applying the above requirements are treated as impairment losses on the individual assets and recognised as outlined above on page 2.

The following diagram demonstrates allocating an impairment loss to assets within a CGU:

1st	**Reduce goodwill**
2nd	**Reduce other assets (as outlined on page 2) on a pro-rata basis using asset carrying amounts at the time the impairment testing is done, subject to the floor**
Floor	**No asset reduced below highest of its FVLCOD, VIU or zero**

The below example illustrates the interaction of these requirements in allocating the impairment loss to individual assets comprising a CGU.

Example 3 – Allocating an impairment loss to assets within a CGU

Entity X carries out an impairment test of CGU 1 on 31 December 20X0. CGU 1 has a total carrying amount of CU800 and consists of two identifiable intangible assets (Asset A, CU400, and Asset B, CU300) in addition to allocated goodwill of CU100. Asset A was also tested for impairment at 31 December 20X0 and found not to be impaired because its FVLCOD (CU450) exceeds its carrying amount (CU400). Management has concluded Asset B's VIU cannot be determined individually and its FVLCOD cannot be measured reliably. The results of the impairment test of CGU 1 show a recoverable amount of CU500; as such, an impairment loss of CU300 must be recognised.

CGU 1	Carrying amount	Recoverable amount (individual asset level)	Impairment loss allocation
Goodwill	100	N/A	100
Asset A	400	450	–
Asset B	300	N/A	200
Total	**800**		
Recoverable amount of CGU 1	500		
Impairment loss	**300**		**300**

Analysis

Entity X first allocates the impairment loss to goodwill. Next, Entity X allocates the remaining impairment loss (in this case CU200) to the individual assets comprising the CGU, subject to the floor. No impairment loss can be allocated to Asset A (due to the floor) as the asset cannot be reduced to less than its recoverable amount. Therefore, the remaining impairment loss of CU200 is allocated to Asset B.

Example 4 – Understanding if the recoverable amount can be determined for individual assets and the effect on recognising an impairment

A machine has suffered physical damage but is still working, although not as well as before it was damaged. The machine's FVLCOD is less than its carrying amount. The machine does not generate independent cash inflows.

The smallest identifiable group of assets that includes the machine and generates cash inflows are largely independent of the cash inflows from other assets, is the production line to which the machine belongs. The recoverable amount of the production line shows the production line (taken as a whole) is not impaired.

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

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

Analysis – Scenario 1

The recoverable amount of the machine alone cannot be estimated because the machine's VIU:

- may differ from its FVLCOD, and
- can be determined only for the CGU 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.

Analysis – Scenario 2

The machine's VIU can be estimated to be close to its FVLCOD. Therefore, the recoverable amount of the machine can be determined. Because the machine's FVLCOD is less than its carrying amount, an impairment loss is recognised for the machine.

Remaining (unallocated) amount of an impairment loss for a CGU

When the requirements above have been applied and result in a remaining unallocated amount of impairment loss for a CGU, such an amount is only recognised as a liability if required by another MFRS.

Practical insight – Any remaining (unallocated) amount of an impairment loss for a CGU

This situation might arise for example, in relation to a loss-making CGU that is in need of restructuring. As noted in our article **'Insights into MFRS 136 – Value in use: estimating future cash inflows and outflows'**, the effects of a future restructuring would be excluded from the VIU estimate before the entity has an obligation for the restructuring in accordance with MFRS 137. Also, the need for future restructuring may result in FVLCOD being negative. In this situation the entity would limit any impairment loss to the carrying value of the CGU's assets and separately evaluate whether the criteria in MFRS 137 to recognise a restructuring provision have been met.

Considerations for foreign operations

Any impairment loss is not a partial disposal for the purposes of MFRS 121 'The Effects of Changes in Foreign Exchange Rates'. The foreign exchange gain or loss recognised in other comprehensive income on translating the foreign operation's financial statements is not therefore reclassified to profit or loss when recognising an impairment.

How we can help

We hope you find the information in this article helpful in giving you some insight into MFRS 136. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact.

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