

## Impairment of fixed assets

- **assets should not be shown at above recoverable amount**
  - general established principle
  - stock, write down if obsolescent
  - debtors, write down if likely to be bad
- **Companies Act 1985, fixed assets to be written down if permanent diminution in value**
- **initially at cost**
- **then the lower of**
  - the carrying amount (the existing value)
  - the recoverable amount which is
    - higher of net realisable and value in use
- **examples**
  - standard case, no change

<u>Carrying amount</u>	<u>NRV</u>	<u>In use</u>
100	80	120
<b>Value= 100</b>		

- reduce value, poor future profits

<u>Carrying amount</u>	<u>NRV</u>	<u>In use</u>
100	60	70
<b>Value= 70</b>		

- reduce, value in alternative use

<u>Carrying amount</u>	<u>NRV</u>	<u>In use</u>
100	80	70
<b>Value= 80</b>		

- **FRS11 in UK but IAS similar**
- **impairment review required if there is any indication of impairment**
- **value in use is a problem**
- **assets need to be grouped**
  - assets don't generate cash independently of each other
  - need a group of assets, "income generating units", that do generate cash largely independently
- **future cash flows**
  - need to predict future cash flows, need to be consistent with up-to-date budgets
  - beyond 5 years, normally assume steady or declining growth
  - steady-declining rate should not exceed long term average for the industry-country
- **risk adjusted discount rate**
  - WACC of similar assets
  - WACC of similar company with similar risk profile
  - WACC of company adjusted for the group of assets
  - too subjective

- **allocation of liabilities and goodwill to "income generating units"**
  - the carrying value of the "income generating units" is the NET carrying amounts of assets, liabilities and goodwill
- **central assets are difficult**
  - exclude central assets if cannot apportion
  - but then impairment review of the central assets
    - but what cash flow would be associated with them?
- **Accounting treatment**
- **generally through the profit and loss**
- **except, if assets have been revalued**
  - revaluation will have gone to reserves
  - then some may be charged to reserves and appear in STRGL

- **Comment**
- **because cash flows are discounted at WACC**
  - asset value is low enough to give the market rate of return
  - arguments for this are OK, except
  - encourages big bath accounting
    - making large write downs in bad years, leaving asset values low and increased profits (through lower depreciation charges) in later years
- **may not improve early recognition of bad news**
  - gives management too much discretion
- **also applicable to goodwill, impairment review *instead* of amortisation in the US. Not clear if will be adopted in IFRS**