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IAS® Standard 36 Impairment of Assets

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CASE STUDY- IAS 36 IMPAIRMENT OF ASSETS

Introduction

Faithfully reflecting the value of financial statement elements contributes to providing relevant information to users, who can make informed decisions based on these reports. To this end, entities are supposed to recognize any impairment for their assets. Asset impairment requires management to exercise their judgment on the best way to proceed, and this process is based on and results in making estimates that should accurately reflect the value entities expect to obtain from their assets over the coming period. Since this process may result in losses being recognized in the entities' financial statements, management may be inclined not to recognize them in a timely manner. Nevertheless, the resulting reported information is biased (not free from errors), not neutral (overestimates assets) and not faithfully representing a relevant phenomenon (that the benefits expected to be realized by the entity from their assets are not as high as it was previously anticipated).

This case study is designed to underline the importance of accurately performing the necessary impairment testing of assets, when conditions require so, and of accurately reporting the consequences of such tests in the entities' financial statements.

The Case Information

You are a junior accountant working with the accounting department of Brown Toy Ltd., a small, listed entity producing toys for small children. Management is concerned about the impact of the recent economic crisis on the financial statements of the entity.

Brown Toy Ltd. produces two types of toys – wooden toys and plastic toys. The entity is organized around the two types of toys, each of these being set up as a department. Mr. Brown, the founder, started his business 30 years ago by producing wooden toys, being initially inspired by his children. Some years later, the company grew by the acquisition of another small producer, focused on plastic toys.

The end of the financial year 20X1is fast approaching (we are now at the end of December 20X1) and management is concerned about the implications of the recent economic crisis that affects Happyland, the country where the entity is based. The demand for toys has abruptly decreased, and it is forecasted to decrease over the following years even more than the initial prospects.

A management meeting will take place soon to discuss the consequences of these events on the financial statements prepared by the entity for the year 20X1. You receive the following excerpts from the preliminary data to be used for the 20X1 financial statements.

Assets	Wooden toys departments (carrying amount, in CU)	Plastic toys department (carrying amount, in CU)	Total
Production line	55,000	35,000	90,000
Other property, plant and equipment	15,000	15,000	30,000
Goodwill		20,000	20,000
Building			20,000
Total	70,000	70,000	160,000

The budgeted data for the two lines of activity are as follows:

Budgeted data	Wooden toys department	Plastic toys department
Units of yearly sales estimated in 20X0 for the next years	20,000 units	12,000 units
Units of yearly sales estimated in 20X1 for the next years	17,000 units	10,000 units
Discounted cash flows for the next 5 years	CU65,340	CU64,000

If the departments would be sold as a whole, their fair value less costs to sell would be CU68,000 for the Wooden toys department, and CU70,000 for the Plastic toys department.

The general manager of Brown Toy Ltd. is concerned that the market decrease might negatively impact how the entity's assets are measured and that losses might have to be reported. However, the manager of the Plastic toys department believes that his department is not affected, and that an impairment test should not be carried out, since this department might be sold at a value that is equal to the carrying amount of the assets.

Discussion Questions

You are asked to prepare a report to the management, addressing the following issues:

1. Does an impairment test need to be conducted, and if so, for which department?
2. What are the consequences of the impairment test and what values need to be reported in the financial statements for the year 20X1?

SOLUTION OF CASE STUDY- IAS 36 IMPAIRMENT OF ASSETS

To: Management of Brown Toy Ltd.

From: Junior accountant

About: Impact of the economic crisis on the value of the entity's assets

1. I assessed the need to conduct an impairment test for the entity's assets. This test would indicate if these assets have lost part of their value, and if losses must be recognized. An impairment test is needed:

a) For the Wooden toys department – because there are external indications (the market has decreased from 20,000 units to 17,000 units) that the value of its assets might have decreased.

b) For the Plastic toys department – this department has allocated goodwill, and a yearly impairment test is needed.

Therefore, the impairment test needs to be conducted at the department level (as independent cash generating units – CGU), for both departments.

2. To conduct the impairment test, the value of the building (corporate asset) must be first allocated to the two departments. Since the assets of the two departments have the same carrying amount, and there are no differences in how these assets are used, we will split evenly the value of the building between the two departments. Then, the carrying amount of the department is compared to its recoverable amount, which is the higher of its value in use (discounted cash flows) and its fair value less costs to sell.

Assets	Wooden toys department (in CU)	Plastic toy department (in CU)
Original carrying amount	70,000	70,000
Building (corporate asset)	10,000	10,000
Total carrying amount	**80,000**	**80,000**
Value in use	65,340	64,000
Fair value less costs to sell	68,000	70,000
Recoverable amount	**68,000**	**70,000**
Loss for the cash generating unit	**12,000**	**10,000**

The loss is allocated first to goodwill, if the cash generating unit has any, and any remaining loss amount is allocated to the assets forming the cash generating unit, pro-rated based on the carrying amount of each asset in the unit.

The Wooden toys department does not have any goodwill. Therefore, the computations related to the impairment loss for this department are the following:

Assets	Original amounts (in CU)	Allocated loss (in CU)	Final amounts (in CU)
Production line	55,000	12,000*55,000/80,000 = 8,250	46,750
Other property, plant and equipment	15,000	12,000*15,000/80,000 = 2,250	12,750
Building	10,000	12,000*10,000/80,000 = 1,500	8,500
Total	80,000	12,000	68,000

The Plastic Toys department has allocated goodwill. Therefore, the computations for this department are the following:

Assets	Original amounts (in CU)	Allocated loss (in CU)	Final amounts (in CU)
Production line	35,000		35,000
Other property, plant and equipment	15,000		15,000
Goodwill	20,000	10,000	10,000
Building	10,000		10,000
Total	80,000	10,000	70,000

The overall impact on the statement of financial position is the following:

Assets	Amount before the impairment test (in CU)	Amount after the impairment test (in CU)
Production line	90,000	81,750
Other property, plant and equipment	30,000	27,750
Goodwill	20,000	10,000
Building	20,000	18,500
Total	160,000	138,000

The statement of profit or loss is impacted by an impairment loss of CU22,000.