ACCOUNTING STANDARDS BOARD JULY 1998 FRS 11

11

IMPAIRMENT OF FIXED ASSETS AND GOODWILL

FINANCIAL REPORTING STANDARD

ACCOUNTING STANDARDS BOARD

Financial Reporting Standard 11
'Impairment of Fixed Assets and Goodwill'
is issued by the Accounting Standards
Board in respect of its application in the
United Kingdom and by the Institute of
Chartered Accountants in Ireland in respect
of its application in the Republic of Ireland.

FINANCIAL REPORTING STANDARD

11

Impairment of Fixed Assets and Goodwill

ACCOUNTING
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Financial Reporting Standard 11 is set out in paragraphs 1–82.

The Statement of Standard Accounting Practice, which comprises the paragraphs set in bold type, should be read in the context of the Objective as stated in paragraph 1 and the definitions set out in paragraph 2 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.

The explanatory paragraphs contained in the FRS shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.

Appendix IV 'The development of the FRS' reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions on the FRS.

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CONTENTS

SUMMARY

a Financial Reporting Standard 11 'Impairment of Fixed Assets and Goodwill' sets out the principles and methodology for accounting for impairments of fixed assets and goodwill. Investments covered by the Accounting Standards Board's project on derivatives and other financial instruments are excluded from the scope of the FRS. Also excluded are investment properties, which are being considered further in the light of other Board projects and the international project on investment properties.

b It would be unnecessarily onerous for all fixed assets and goodwill to be tested for impairment every year. In general, fixed assets and goodwill need be reviewed for impairment only if there is some indication that impairment has occurred. (Requirements for additional impairment reviews of goodwill and intangible assets in certain circumstances are included in FRS 10 'Goodwill and Intangible Assets'.)

c Where possible, individual fixed assets should be tested for impairment. However, impairment can often be tested only for groups of assets because the cash flows upon which the calculation is based do not arise from the use of a single asset. In these cases, impairment is measured for the smallest group of assets (the income-generating unit) that produces a largely independent income stream, subject to constraints of practicality and materiality.

d Impairment is measured by comparing the carrying value of the fixed asset or income-generating unit with its recoverable amount. The recoverable amount is the higher of the amounts that can be obtained from selling the fixed asset or income-generating unit (net realisable value) or using the fixed asset or income-generating unit (value in use).

e Net realisable value is the expected proceeds of selling the fixed asset or income-generating unit less any direct selling costs. Value in use is calculated by discounting the expected cash flows arising from the use of the fixed asset or assets in the income-generating unit at the rate of return that the market would expect from an equally risky investment.

f In some cases a detailed calculation of value in use will not be necessary. A simple estimate may be sufficient to demonstrate that either value in use is higher than carrying value, in which case there is no impairment, or value in use is lower than net realisable value, in which case impairment is measured by reference to net realisable value.

g If an acquisition that gives rise to goodwill is merged with an existing business, the requirements of the FRS necessitate the calculation of the amount of any internally generated goodwill in the existing business at the date of the merger because that amount will need to be used in the calculation of any subsequent impairment loss in the merged business.

h The reversal of past impairment losses is recognised when the recoverable amount of a tangible fixed asset or investment in a subsidiary, an associate or a joint venture has increased because of a change in economic conditions or in the expected use of the asset. Increases in the recoverable amount of goodwill and intangible assets are recognised only when an external event caused the recognition of the impairment loss in previous periods, and subsequent external events clearly and demonstrably reverse the effects of that event in a way that was not foreseen in the original impairment calculations.

i Impairment losses are recognised in the profit and loss account, unless they arise on a previously revalued fixed asset. Impairment losses on revalued fixed assets are recognised in the statement of total recognised gains and losses until the carrying value of the asset falls below depreciated historical cost unless the impairment is clearly caused by a consumption of economic benefits, in which case the loss is recognised in the profit and loss account. Impairments below depreciated historical cost are recognised in the profit and loss account.

FINANCIAL REPORTING STANDARD 11

Objective

1 The objective of this FRS is to ensure that:

(a) fixed assets and goodwill are recorded in the financial statements at no more than their recoverable amount;

(b) any resulting impairment loss is measured and recognised on a consistent basis; and

(c) sufficient information is disclosed in the financial statements to enable users to understand the impact of the impairment on the financial position and performance of the reporting entity.

Definitions

2 The following definitions shall apply in the FRS and in particular in the Statement of Standard Accounting Practice set out **in bold type**.

Impairment:-

A reduction in the recoverable amount of a fixed asset or goodwill below its carrying amount.

Income-generating unit:-

A group of assets, liabilities and associated goodwill that generates income that is largely independent of the reporting entity's other income streams. The assets and liabilities include those directly involved in generating the income and an appropriate portion of those used to generate more than one income stream.

Intangible assets:-

Non-financial fixed assets that do not have physical substance but are identifiable and controlled by the entity through custody or legal rights.

Net realisable value:-

The amount at which an asset could be disposed of, less any direct selling costs.

Purchased goodwill:-

The difference between the cost of an acquired entity and the aggregate of the fair values of that entity's identifiable assets and liabilities.

Readily ascertainable market value:-

In relation to an intangible asset, the value that is established by reference to a market where:

(a) the asset belongs to a homogeneous population of assets that are equivalent in all material respects; and

(b) an active market, evidenced by frequent transactions, exists for that population of assets.

Recoverable amount:-

The higher of net realisable value and value in use.

Tangible fixed assets:-

Assets that have physical substance and are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes on a continuing basis in the reporting entity's activities.

Value in use:-

The present value of the future cash flows obtainable as a result of an asset's continued use, including those resulting from its ultimate disposal.

Scope

3 **The FRS applies to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure) for a period.**

4 **Reporting entities applying the Financial Reporting Standard for Smaller Entities (FRSSE) are exempt from the FRS unless preparing consolidated financial statements, in which case they should apply the FRS to such statements as required by the FRSSE.***

5 **The requirements of the FRS apply to purchased goodwill that is recognised in the balance sheet and all fixed assets, except:**

(a) fixed assets within the scope of the FRS addressing disclosures of derivatives and other financial instruments;

(b) investment properties as defined in SSAP 19 'Accounting for investment properties';

* *Reporting entities applying the FRSSE are generally exempt from applying this FRS. However, if they prepare consolidated financial statements, the FRSSE in force at the date of the publication of this FRS requires them to apply SSAP 22 to purchased goodwill arising on consolidation. It is envisaged that a future revision of the FRSSE will require smaller entities adopting the FRSSE and preparing consolidated financial statements to replace that reference to SSAP 22 with an equivalent reference to FRS 10 and this FRS.*

(c) an entity's own shares held by an ESOP and shown as a fixed asset in the entity's balance sheet under UITF Abstract 13 'Accounting for ESOP Trusts'; and

(d) costs capitalised pending determination (ie costs capitalised while a field is still being appraised) under the Oil Industry Accounting Committee's SORP 'Accounting for oil and gas exploration and development activities'.

6 Many investments are covered by the Accounting Standards Board's project on derivatives and other financial instruments and hence are excluded from this FRS. However, investments in subsidiary undertakings, associates and joint ventures are excluded from the scope of that project and are, therefore, included within the scope of this FRS.

7 The FRS does not apply to purchased goodwill that was written off to reserves under SSAP 22 'Accounting for goodwill' and has not been recognised on the balance sheet under FRS 10 'Goodwill and Intangible Assets'.

Indications of impairment

8 **A review for impairment of a fixed asset or goodwill should be carried out if events or changes in circumstances indicate that the carrying amount of the fixed asset or goodwill may not be recoverable.**

9 Impairment occurs because something has happened either to the fixed assets themselves or to the economic environment in which the fixed assets are operated. It is possible, therefore, to rely on the use of indicators of impairment to determine when a review for impairment is needed.

10 Examples of events and changes in circumstances that indicate an impairment may have occurred include:

- a current period operating loss in the business in which the fixed asset or goodwill is involved or net cash outflow from the operating activities of that business, combined with either past operating losses or net cash outflows from such operating activities or an expectation of continuing operating losses or net cash outflows from such operating activities

- a significant decline in a fixed asset's market value during the period

- evidence of obsolescence or physical damage to the fixed asset

- a significant adverse change in:

  - either the business or the market in which the fixed asset or goodwill is involved, such as the entrance of a major competitor

  - the statutory or other regulatory environment in which the business operates

  - any 'indicator of value' (for example turnover) used to measure the fair value of a fixed asset on acquisition

- a commitment by management to undertake a significant reorganisation

- a major loss of key employees

- a significant increase in market interest rates or other market rates of return that are likely to affect materially the fixed asset's recoverable amount.

11 The above indicators of impairment will trigger an impairment review only if they are relevant to the measurement of goodwill or fixed assets. For example, short-term market interest rates may increase without affecting the rate of return the market would require on long-term assets, with the result that there is no effect on the recoverable amount of such assets. Such increases in short-term rates would not trigger an impairment review.

12 If any such events or changes in circumstances are identified, a review of the useful economic lives and residual values of the fixed assets or goodwill affected is appropriate: even if the fixed assets or goodwill are not impaired, their remaining useful economic lives and residual values may have changed as a result of the events or changes in circumstances.

13 The requirements of this FRS are such that if no such events or changes in circumstances are identified, and there are no other indications that a tangible fixed asset or investment in a subsidiary, associate or joint venture has become impaired, there is no requirement for an impairment review. For tangible fixed assets, impairments will therefore be a relatively infrequent addition to depreciation. Additional requirements to perform impairment reviews for goodwill and intangible assets that are amortised over periods of more than 20 years or not at all are set out in FRS 10 'Goodwill and Intangible Assets'.

Recognition and measurement of impairment losses

14 **The impairment review should comprise a comparison of the carrying amount of the fixed asset or goodwill with its recoverable amount (the higher of net realisable value and value in use). To the extent that the carrying amount exceeds the recoverable amount, the fixed asset or goodwill is impaired and should be written**

down. The impairment loss should be recognised in the profit and loss account unless it arises on a previously revalued fixed asset, in which case it should be recognised as required by paragraph 63.

15 If either net realisable value or value in use is higher than the carrying amount of a fixed asset or goodwill, the fixed asset or goodwill is not impaired and there is no need to calculate the other amount.

16 If no reliable estimate of net realisable value can be made, the recoverable amount is determined by value in use alone.

17 If net realisable value is lower than the carrying amount of the fixed asset, before writing down the asset to net realisable value it is necessary to establish whether value in use is higher. If it is, the recoverable amount will be based on value in use, not net realisable value.

18 Requirements and guidance relating to the calculation of net realisable value and value in use are set out in paragraphs 22-46 below. In many cases, a detailed calculation of value in use will not be necessary because a simple estimate will be sufficient to demonstrate that value in use is either above carrying value, in which case there is no impairment, or is below net realisable value, in which case the recoverable amount will not be based on value in use.

19 In determining whether recoverable amount should be based on value in use or net realisable value, the deferred tax balances that would arise in each case need to be taken into account. For example, if net realisable value is £100 and would give rise to a deferred tax liability of £30 and value in use is £110 and would give rise to a deferred tax liability of £45, recoverable amount is based on net realisable value.

20 If a fixed asset is not held for the purpose of generating cash flows either by itself or in conjunction with other assets, for example certain fixed assets held for charitable purposes, it is not appropriate to measure the asset at an amount based on expected future cash flows. In such cases it may not be appropriate to write down the fixed asset to its recoverable amount—an alternative measure of its service potential may be more relevant.

21 **When an impairment loss on a fixed asset or goodwill is recognised, the remaining useful economic life and residual value should be reviewed and revised if necessary. The revised carrying amount should be depreciated over the revised estimate of the remaining useful economic life.**

Calculation of net realisable value

22 The net realisable value of an asset that is traded on an active market will be based on market value.

23 Net realisable value is defined as the amount at which an asset could be disposed of, less any direct selling costs. Examples of direct selling costs are legal costs and stamp duty. Any costs relating to the removal of a sitting tenant are also direct selling costs of a building. However, costs associated with reducing or reorganising the business rather than selling the fixed asset, such as redundancy costs incurred when a factory is sold, are not direct selling costs.

Calculation of value in use

24 **The value in use of a fixed asset should be estimated individually where reasonably practicable. Where it is not reasonably practicable to identify cash flows arising from an individual fixed asset, value in use should be calculated at the level of income-generating units. The carrying amount of each income-generating unit containing the fixed asset or goodwill under review should be compared with the higher of the value in use and the net realisable value (if it can be measured reliably) of the unit.**

25 The value in use of a fixed asset is the present value of the future cash flows obtainable as a result of the asset's continued use, including those resulting from its ultimate disposal. In practice, it is not normally possible to estimate the value in use of an individual fixed asset: it is the utilisation of groups of assets and liabilities, together with their associated goodwill, that generates cash flows. Hence value in use will usually have to be estimated in total for groups of assets and liabilities. These groups are referred to as income-generating units.

26 Because it is necessary to identify only material impairments, in some cases it may be acceptable to consider a group of income-generating units together rather than on an individual basis.

Income-generating units

27 **Income-generating units should be identified by dividing the total income of the entity into as many largely independent income streams as is reasonably practicable. Except as permitted by paragraph 32, each of the identifiable assets and liabilities of the entity, excluding deferred tax**

balances, interest-bearing debt, dividends payable and other items relating wholly to financing, should be attributed to (or apportioned between) one (or more) income-generating unit(s).

28 To perform impairment reviews as accurately as possible:

- the groups of assets and liabilities that are considered together should be as small as is reasonably practicable, but

- the income stream underlying the future cash flows of one group should be largely independent of other income streams of the entity and should be capable of being monitored separately.

Income-generating units are therefore identified by dividing the total income of the business into as many largely independent income streams as is reasonably practicable in the light of the information available to management.

29 In general terms, the income streams identified are likely to follow the way in which management monitors and makes decisions about continuing or closing the different lines of business of the entity. Unique intangible assets, such as brands and mastheads, are generally seen to generate income independently of each other and are usually monitored separately. Hence they can often be used to identify income-generating units. Other income streams may be identified by reference to major products or services.

Examples 1-4:
Identification of income-generating units

Example 1

A transport company runs a network comprising trunk routes fed by a number of supporting routes. Decisions about continuing or closing the supporting routes are not based on the returns generated by the routes in isolation but on the contribution made to the returns generated by the trunk routes.

An income-generating unit comprises a trunk route plus the supporting routes associated with it because the cash inflows generated by the trunk routes are not independent of the supporting routes.

Example 2

A manufacturer can produce a product at a number of different sites. Not all the sites are used to full capacity and the manufacturer can choose how much to make at each site. However, there is not enough surplus capacity to enable any one site to be closed. The cash inflows generated by any one site therefore depend on the allocation of production across all sites.

The income-generating unit comprises all the sites at which the product can be made.

Example 3

A restaurant chain has a large number of restaurants across the country. The cash inflows of each restaurant can be individually monitored and sensible allocations of costs to each restaurant can be made.

Continued...

Each restaurant is an income-generating unit by itself. However, any impairment of individual restaurants is unlikely to be material. A material impairment is likely to occur only when a number of restaurants are affected together by the same economic factors. It may therefore be acceptable to consider groupings of restaurants affected by the same economic factors rather than each individual restaurant.

Example 4

An entity comprises three stages of production, A (growing and felling trees), B (creating parts of wooden furniture) and C (assembling the parts from B into finished goods). The output of A is timber that is partly transferred to B and partly sold in an external market. If A did not exist, B could buy its timber from the market. The output of B has no external market and is transferred to C at an internal transfer price. C sells the finished product in an external market and the sales revenue achieved by C is not affected by the fact that the three stages of production are all performed by the entity (unlike example 1, where the sales revenue of the trunk routes is affected by the existence of supporting routes run by the same entity).

A forms an income-generating unit and its cash inflows should be based on the market price for its output. B and C together form one income-generating unit because there is no market available for the output of B. In calculating the cash outflows of the income-generating unit B+C, the timber received by B from A should be priced by reference to the market, not any internal transfer price.

30 Income-generating units are defined by allocating the assets and liabilities of the reporting entity, excluding deferred tax balances, interest-bearing debt, dividends payable and other items relating wholly to financing, to the identified income streams. Certain assets and liabilities that are directly involved in the production and distribution of individual products may be attributed directly to one unit. Central assets, such as group or regional head offices, and working capital may have to be apportioned across the units on a logical and systematic basis. The resulting income-generating units will be complete and non-overlapping, so that the sum of the carrying amounts of the units equals the carrying amount of the net assets (excluding tax and financing items) of the entity as a whole, as illustrated in example 5 opposite.

Example 5: Allocation of head office assets to income-generating units

An entity has three independent income streams, A, B and C, with net assets directly involved in the income streams with carrying amounts of £100 million, £150 million and £200 million respectively. In addition there are head office net assets with a carrying amount totalling £18 million. The relative proportion of the head office resources used by the income streams is 2:3:4. The income-generating units are defined as follows:

Income-generating unit	A	B	C	Total
Net assets directly attributable to income-generating unit (£ million)	100	150	200	450
Head office net assets (£ million)	4	6	8	18
Total (£ million)	104	156	208	468

If there were an indication that a fixed asset in income-generating unit B was impaired, the recoverable amount of B would be compared with £156 million, not £150 million. Similarly, the cash flows upon which the value in use of B is based would include the relevant portion of any cash outflows arising from central overheads.

31 The income stream of a fixed asset to be disposed of will be largely independent of the income stream of other assets. Such an asset therefore forms an income-generating unit of its own and does not belong to any other income-generating unit.

Central assets

32 **If it is not possible to apportion certain central assets meaningfully across the income-generating units to which they contribute, these assets may be excluded from the individual income-generating units. However, an additional impairment review should be performed on the excluded central assets. In this review, the income-generating units to which the central assets contribute should be combined and their combined carrying amount (including that of the central assets) should be compared with their combined value in use.**

Example 6:
Alternative approach to allocation of head office assets to income-generating units

With this approach, in example 5 above the recoverable amount of B would be compared with £150 million, not £156 million. Then a further impairment test would be required on the whole entity comparing its recoverable amount with the total carrying value of £468 million.

33 If there is any working capital in the balance sheet that will generate cash flows equal to its carrying amount, the carrying amount of the working capital may be excluded from the income-generating units and the cash flows arising from its realisation/settlement excluded from the value in use calculation.

34 **Capitalised goodwill should be attributed to (or apportioned between) income-generating units or groups of similar units. If they were acquired as part of the same investment and are involved in similar parts of the business, individual units identified for the purpose of monitoring the recoverability of assets may be combined with other units to enable the recoverability of the related goodwill to be assessed.**

35 Goodwill is allocated to income-generating units in the same way as are the assets and liabilities of the entity. However, where several similar income-generating units are acquired together in one investment, the units may be combined to assess the recoverability of the goodwill. The income-generating units are first reviewed individually for the purposes of assessing the recoverability of any capitalised intangible assets and tangible fixed assets and then, as illustrated in example 7 below, the combined unit is reviewed to assess the recoverability of the goodwill.

Example 7: Alternative approach to allocation of goodwill to income-generating units

An entity acquires a business comprising three income-generating units, A, B and C. After five years, the carrying amount of the net assets in the income-generating units and the purchased goodwill compares with the value in use as follows (there is no reliable estimate of net realisable value for any of the income-generating units or the business as a whole):

Income-generating unit	A	B	C	Goodwill	Total
Carrying amount (£ million)	80	120	140	50	390
Value in use (£ million)	100	140	120		360

An impairment loss of £20 million is recognised in respect of income-generating unit C, reducing its carrying amount to £120 million and the total carrying amount to £370 million. A further impairment loss of £10 million is then recognised in respect of the goodwill.

Cash flows

36 **The expected future cash flows of the income-generating unit, including any allocation of central overheads but excluding cash flows relating to financing and tax, should be based on reasonable and supportable assumptions. The cash flows should be consistent with the most up-to-date budgets and plans that have been formally approved by management. Cash flows for the period beyond that covered by formal budgets and plans should assume a steady or declining growth rate. Only in exceptional circumstances should:**

(a) the period before the steady or declining growth rate is assumed extend to more than five years; or

(b) the steady or declining growth rate exceed the long-term average growth rate for the country or countries in which the business operates.*

37 In exceptional circumstances, the use of a long-term growth rate that is higher than the average country growth rate may be justified. This may, for example, be the case where:

(a) the long-term growth rate for the relevant industry is expected to be significantly higher than the relevant country growth rate; and

(b) the business under review is expected to grow as rapidly as the industry as a whole, taking into account the likelihood of new competitors entering such an industry.

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* *The UK post-war average growth in gross domestic product, expressed in real terms, is 2.25 per cent (source: Financial Statement and Budget Report March 1998, HM Treasury)*

38 **Subject to paragraph 39 below, future cash flows should be estimated for income-generating units or individual fixed assets in their current condition. They should not include:**

(a) future cash outflows or related cost savings (for example reductions in staff costs) or benefits that are expected to arise from a future reorganisation for which provision has not yet been made; or

(b) future capital expenditure that will improve or enhance the income-generating units or assets in excess of their originally assessed standard of performance or the related future benefits of this future expenditure.

39 **In the case of a newly acquired income-generating unit such as a subsidiary, the purchase price will reflect the synergies and other opportunities for making more effective use of the assets as a result of the acquisition. In some of these cases, in order to obtain the benefits from its investment, it may be necessary for the purchaser to undertake related capital expenditure and reorganisations. Consequently, in assessing the future cash flows of the investment, the costs and benefits of such reorganisations and capital expenditure anticipated at the time of performing impairment reviews up to the end of the first full year after acquisition and consistent with budgets and plans at that time may be taken into account in those and subsequent impairment reviews, to the extent that the investment or reorganisations are still to be incurred.**

40 Failure to undertake capital investment or a reorganisation according to the planned schedule may call into question the validity of continuing to forecast that the investment or reorganisation will be undertaken in the future and may be an indication of impairment as discussed in paragraphs 8-13. The costs and benefits of the investment or reorganisation would then have to be omitted from forecasts performed for subsequent impairment reviews. Additionally, the monitoring of cash flows required by paragraph 54 may indicate that impairment has already occurred.

Discount rate

41 **The present value of the income-generating unit under review should be calculated by discounting the expected future cash flows of the unit. The discount rate used should be an estimate of the rate that the market would expect on an equally risky investment. It should exclude the effects of any risk for which the cash flows have been adjusted and should be calculated on a pre-tax basis.**

42 Estimates of this market rate may be made by a variety of means including reference to:

(a) the rate implicit in market transactions of similar assets;

(b) the current weighted average cost of capital (WACC) of a listed company whose cash flows have similar risk profiles to those of the income-generating unit; or

(c) the WACC for the entity *but only if* adjusted for the particular risks associated with the income-generating unit.

43 If method (c) is used the following matters are of note.

- Where the cash flow forecasts assume a real growth rate that exceeds the long-term average growth rate for more than five years, it is likely that the discount rate will be increased to reflect a higher level of risk.

- The discount rates applied to individual income-generating units will always be estimated such that, were they to be calculated for every unit, the weighted average discount rate would equal the entity's overall WACC.

44 The WACC will be a post-tax rate from the entity's point of view, whereas the required discount rate will be a pre-tax rate. Some of the issues that need to be considered in adjusting from a post-tax rate to a pre-tax rate are discussed in Appendix I.

45 Using a discount rate equal to the rate of return that the market would expect on an equally risky investment is a method of reflecting the risk associated with the cash flows in the value in use measurement. It is likely that this method will be the easiest method of reflecting risk. However, an acceptable alternative is to adjust the cash flows for risk and to discount them using a risk-free rate (eg a government bond rate). Whichever method of reflecting risk is adopted, care must be taken that the effect of risk is not double-counted by inclusion in both the cash flows and the discount rate.

46 If the cash flows to be discounted are expressed in current prices, a real discount rate will be used. If the cash flows are expressed in expected future prices, a nominal discount rate will be used.

Allocation of impairment losses

47 **The carrying amounts of the income-generating units under review should be calculated as the net of the carrying amounts of the assets, liabilities and goodwill allocated to the unit.**

48 **To the extent that the carrying amount of the income-generating unit exceeds its recoverable amount, the unit is impaired. In the absence of an obvious impairment of specific assets within the unit, the impairment should be allocated:**

(a) first, to any goodwill in the unit;

(b) thereafter, to any capitalised intangible asset in the unit; and

(c) finally, to the tangible assets in the unit, on a pro rata or more appropriate basis.

49 **In this allocation, which aims to write down the assets with the most subjective valuations first, no intangible asset with a readily ascertainable market value should be written down below its net realisable value. Similarly, no tangible asset with a net realisable value that can be measured reliably should be written down below its net realisable value.**

Allocation when acquired businesses are merged with existing operations

50 **Where an acquired business is merged with an existing business and results in an income-generating unit that contains both purchased and (unrecognised) internally generated goodwill:**

(a) the value of the internally generated goodwill of the existing business at the date of merging the businesses should be estimated and added to the carrying amount of the income-generating unit for the purposes of performing impairment reviews;*

(b) any impairment arising on merging the businesses should be allocated solely to the purchased goodwill within the newly acquired business;

(c) subsequent impairments should be allocated pro rata between the goodwill of the acquired business and that of the existing business;

(d) the impairment allocated to the existing business should be allocated first to the (notional) internally generated goodwill; and

(e) only the impairments allocated to purchased goodwill (and, if necessary, to any recognised intangible or tangible assets) should be recognised in the financial statements.

51 An acquired business may be merged with an existing operation of the reporting entity in such a way that a single income-generating unit includes the assets and liabilities of both the acquired and the existing businesses. This combined income-generating unit contains both acquired and internally generated goodwill and any future impairment needs to be apportioned between the two. This can be done by notionally adjusting the carrying amount of the income-generating unit to recognise a notional carrying amount for the internally generated goodwill of the existing operation at the date of merging the two businesses.

* *The internally generated goodwill will not be recognised in the financial statements.*

52 The notional carrying amount of the internally generated goodwill is estimated by deducting the fair values of the net assets and purchased goodwill within the existing income-generating unit from its estimated value in use before combining the businesses. This calculation will need to be done whenever an acquisition that gives rise to goodwill is merged with an existing business. The notional balance is assumed to be subject to the same pattern of amortisation as is applied to the purchased goodwill.

53 Because the comparison with value in use will have resulted in the recognition of any impairment of the existing business at the time of merging it with the acquired business, any initial impairment in the combined income-generating unit will, by definition, relate to the acquired business. Any subsequent impairment cannot be attributed directly to either the acquired or the existing businesses and is therefore apportioned between the notional internally generated goodwill and the purchased goodwill pro rata to their current carrying values.

Example 8: Allocation of impairment losses when an acquired business is merged with existing operations

Assumptions

An entity acquires for £60 million a business having net assets with a total fair value of £40 million, resulting in purchased goodwill of £20 million. The acquired business is merged with an existing operation that has net assets with a fair value of £100 million and a carrying amount of £70 million. The value in use of the existing operation at the time of the acquisition is £150 million, implying that the existing operation had internally generated goodwill of £50 million. *Continued...*

Five years later, the carrying amount of the net assets of the combined income-generating unit is £105 million and the carrying amount of the purchased goodwill is £10 million (goodwill is being amortised over 10 years). Value in use is £119 million and there is no reliable estimate of net realisable value.

Calculation of impairment loss	*£m*
Carrying amount of net assets	105
Carrying amount of goodwill	10
Notional carrying amount of the internally generated goodwill at the date of acquisition (assuming notional amortisation on same basis as for purchased goodwill)	25
Total	140
Value in use	119
Impairment	21

The impairment is allocated on a pro rata basis (2:5) to the purchased goodwill and internally generated goodwill, resulting in the recognition of an impairment loss of £6 million and purchased goodwill being written down to £4 million.

If value in use were £98 million, the resulting total impairment loss of £42 million would be allocated first to the goodwill (purchased and notional amount of internally generated) of £35 million, then to any intangible assets, then to the tangible fixed assets in the income-generating unit, resulting in the recognition of an impairment loss of £17 million (write-down of purchased goodwill £10 million, write-down of intangible and tangible assets £7 million).

Subsequent monitoring of cash flows

54 **For the five years following each impairment review where the recoverable amount has been based on value in use, the cash flows achieved should be compared with those forecast. If the actual cash flows are so much less than those forecast that use of the actual cash flows could have required recognition of an impairment in previous periods, the original impairment calculations should be re-performed using the actual cash flows. Any impairment identified should be recognised in the current period unless the impairment has reversed and the reversal of the loss is permitted to be recognised by paragraph 56 or 60 below.**

55 In order to check whether an impairment would have arisen, the original calculation is re-performed using the cash flows that have actually occurred but without revising any other cash flows or assumptions (except those that change as a direct consequence of the occurrence of the actual cash flows, eg where a major cash inflow has been delayed for a year). If this recalculation identifies an impairment, the loss should be recognised in the current period. However, the entity may also recalculate value in use using revised assumptions in order to assess the current value in use. If this current value in use shows a reversal of the impairment that would have been recognised had the actual cash flows been used in the original calculation, and that reversal is permitted to be recognised under the FRS, recognition of an impairment loss is not required. Instead, the impairment that would have been recognised and its subsequent reversal are disclosed (paragraph 71).

Reversal of past impairments

Tangible fixed assets and investments in subsidiaries, associates and joint ventures

56 **If, after an impairment loss has been recognised, the recoverable amount of a tangible fixed asset or investment increases because of a change in economic conditions or in the expected use of the asset, the resulting reversal of the impairment loss should be recognised in the current period to the extent that it increases the carrying amount of the fixed asset up to the amount that it would have been had the original impairment not occurred. The reversal of the impairment loss should be recognised in the profit and loss account unless it arises on a previously revalued fixed asset, in which case it should be recognised as required by paragraph 66.**

57 Events and circumstances that are the reverse of those set out in paragraph 10 as triggers for an impairment review may indicate that the recoverable amount of a fixed asset has increased. The increase in the recoverable amount must arise from a change in economic conditions or in the expected use of the asset. This would include situations where the recoverable amount increases as a result of further capital investment or a reorganisation, the benefits of which had been excluded from the original measurement of value in use.

58 Increases in value in use may arise simply because of:

(a) the passage of time: as future cash inflows become closer, their discounted value increases. (Where value in use has been calculated using cash flows based on current prices and a real discount rate, value in use may also increase because of the effect of general inflation on current prices.)

(b) the occurrence of forecast cash outflows: once the cash outflows are past, they are no longer part of the value in use calculation and value in use therefore increases.

Such increases in value may not be recognised as reversals of an impairment loss.

59 The recognition of an increase in the recoverable amount of a tangible fixed asset above the amount that its carrying amount would have been had the original impairment not occurred is a revaluation, not a reversal of an impairment.

Goodwill and intangible assets

60 **The reversal of an impairment loss on intangible assets and goodwill should be recognised in the current period if, and only if:**

(a) an external event caused the recognition of the impairment loss in previous periods, and subsequent external events clearly and demonstrably reverse the effects of that event in a way that was not foreseen in the original impairment calculations; or

(b) the impairment loss arose on an intangible asset with a readily ascertainable market value and the net realisable value based on that market value has increased to above the intangible asset's impaired carrying amount.

61 **The reversal of the impairment loss should be recognised to the extent that it increases the carrying amount of the goodwill or intangible asset up to the amount that it would have been had the original impairment not occurred.**

62 The recognition of an increase in the recoverable amount of an intangible asset above the amount that its carrying amount would have been had the original impairment not occurred is a revaluation and is addressed by FRS 10 'Goodwill and Intangible Assets'.

Example 9: Allocation and reversal of impairment losses

Assumptions

An income-generating unit comprising a factory, plant and equipment etc and associated purchased goodwill becomes impaired because the product it makes is overtaken by a technologically more advanced model produced by a competitor. The recoverable amount of the income-generating unit falls to £60 million, resulting in an impairment loss of £80 million, allocated as follows:

	Carrying amounts before impairment £m	Carrying amounts after impairment £m
Goodwill	40	-
Patent (with no market value)	20	-
Tangible fixed assets	80	60
Total	140	60

After three years, the entity makes a technological breakthrough of its own, and the recoverable amount of the income-generating unit increases to £90 million. The carrying amount of the tangible fixed assets had the impairment not occurred would have been £70 million.

Continued...

Calculation of reversal of the impairment loss

The reversal of the impairment loss is recognised to the extent that it increases the carrying amount of the tangible fixed assets to what it would have been had the impairment not taken place, ie a reversal of £10 million of the impairment loss is recognised and the tangible fixed assets written back to £70 million. Reversal of the impairment is not recognised in relation to the goodwill and patent because the effect of the external event that caused the original impairment has not reversed—the original product is still overtaken by a more advanced model.

Revalued fixed assets

63 **An impairment loss on a revalued fixed asset should be recognised in the profit and loss account if it is caused by a clear consumption of economic benefits. Other impairments of revalued fixed assets should be recognised in the statement of total recognised gains and losses until the carrying amount of the asset reaches its depreciated historical cost and thereafter in the profit and loss account.**

64 An impairment loss arises on a revalued fixed asset whenever the recoverable amount of the asset falls below its carrying amount. In particular, a downward revaluation may comprise, at least in part, an impairment loss. Some of these impairments are caused by a consumption of economic benefits, for example physical damage or a deterioration in the quality of the service provided by the asset, and are operating costs similar to depreciation.

65 Other impairments of revalued fixed assets may result from general changes in prices, for example a general slump in the property market, and are recognised in the statement of total recognised gains and losses as valuation adjustments until the carrying amount of the asset reaches its depreciated historical cost, and thereafter in the profit and loss account.

66 **A reversal of an impairment loss should be recognised in the profit and loss account to the extent that the original impairment loss (adjusted for subsequent depreciation) was recognised in the profit and loss account. Any remaining balance of the reversal of an impairment should be recognised in the statement of total recognised gains and losses.**

Presentation and disclosure

67 **Impairment losses recognised in the profit and loss account should be included within operating profit under the appropriate statutory heading, and disclosed as an exceptional item if appropriate. Impairment losses recognised in the statement of total recognised gains and losses should be disclosed separately on the face of that statement.**

68 **In the notes to the financial statements in accounting periods after the impairment, the impairment loss should be treated as follows:**

(a) for assets held on a historical cost basis, the impairment loss should be included within cumulative depreciation: the cost of the asset should not be reduced.

(b) for revalued assets held at a market value (eg existing use value or open market value), the impairment loss should be included within the revalued carrying amount.

(c) for revalued assets held at depreciated replacement cost, an impairment loss charged to the profit and loss account should be included within cumulative depreciation: the carrying amount of the asset should not be reduced; an impairment loss charged to the statement of total recognised gains and losses should be deducted from the carrying amount of the asset.

69 **If the impairment loss is measured by reference to value in use of a fixed asset or income-generating unit, the discount rate applied to the cash flows should be disclosed. If a risk-free discount rate is used, some indication of the risk adjustments made to the cash flows should be given.**

70 **Where an impairment loss recognised in a previous period is reversed in the current period, the financial statements should disclose the reason for the reversal, including any changes in the assumptions upon which the calculation of recoverable amount is based.**

71 **Where an impairment loss would have been recognised in a previous period had the forecasts of future cash flows been more accurate but the impairment has reversed and the reversal of the loss is permitted to be recognised, the impairment now identified and its subsequent reversal should be disclosed.**

72 **Where, in the measurement of value in use, the period before a steady or declining long-term growth rate has been assumed extends to more than five years, the financial statements should disclose the length of the longer period and the circumstances justifying it.**

73 **Where, in the measurement of value in use, the long-term growth rate used has exceeded the long-term average growth rate for the country or countries in which the business operates, the financial statements should disclose the growth rate assumed and the circumstances justifying it.**

Date from which effective and transitional arrangements

74 **The accounting practices set out in the FRS should be regarded as standard in respect of financial statements relating to accounting periods ending on or after 23 December 1998. Earlier adoption is encouraged but not required.**

75 **Impairment losses recognised when the standard is implemented for the first time are not the result of a change in accounting policy and should be recognised in accordance with the requirements of the FRS and not as prior period adjustments.**

76 The requirement that fixed assets should not be held at more than recoverable amount is a well-established principle. Achieving this objective by applying the method prescribed in the FRS is not a change in accounting policy but is similar to a change in accounting estimate.

Amendment of other accounting standards

77 **The FRS supersedes paragraphs 19 and 20 of SSAP 12 'Accounting for depreciation' and the last sentence in paragraph 22 is amended to:**

> **"**Depreciation charged before the revaluation should not be written back to the profit and loss account.**"**

78 **In the appendix to SSAP 17 'Accounting for post balance sheet events', examples (b) and (c) of adjusting events are amended to:**

> **"**(b) *Property:* A valuation that provides evidence of an impairment in value.
>
> (c) *Investments:* The receipt of a copy of the financial statements or other information in respect of an unlisted company that provides evidence of an impairment in the value of a long-term investment.**"**

79 **FRS 2 'Accounting for Subsidiary Undertakings' is amended as follows:**

(a) the second sentence of paragraph h(i) of the summary becomes

> **"**They are to be included at their carrying amount when the restrictions came into force, subject to any write-down for impairment, and no further accruals are to be made for profits or losses of those subsidiary undertakings, unless the parent undertaking still exercises significant influence.**"**

(b) the fifth and sixth sentences of paragraph 27 become

"The carrying amount of subsidiary undertakings subject to severe long-term restrictions should be reviewed and written down for any impairment in value. When impairment is assessed, each subsidiary undertaking should be considered individually.**"**

(c) the second sentence of paragraph 28 becomes

"Similarly, any amount previously charged for impairment that needs to be written back as a result of restrictions ceasing should be separately disclosed.**"**

(d) the fifth sentence in paragraph 79(a) becomes

"Because severe long-term restrictions may give rise to impairments, the FRS requires the value of the excluded subsidiary undertaking to be reviewed to assess whether any impairment has occurred.**"**

(e) the eighth and ninth sentences in paragraph 89 become

"For example, where such an investment has been written down because it is impaired, the effect of applying the Schedule 4A paragraph 9 method of acquisition accounting would be to increase reserves and create an asset (goodwill). In the rare cases where the Schedule 4A paragraph 9 calculation of goodwill would be misleading, goodwill should be calculated as the sum of goodwill arising from each purchase of an interest in the relevant undertaking adjusted as necessary for any subsequent impairment.**"**

80 In FRS 3 'Reporting Financial Performance', the last sentence of paragraph 45 is amended to

> **"**In accordance with normal practice, however, any impairments in asset values should be recorded.**"**

81 FRS 10 'Goodwill and Intangible Assets' is amended as follows:

(a) paragraph 39 becomes

> **"Except as permitted in paragraph 40, impairment reviews should be performed in accordance with the requirements of FRS 11 'Impairment of Fixed Assets and Goodwill'."**

(b) paragraph 40(b) becomes

> **"(b) performing a full impairment review in accordance with the requirements of FRS 11 only if the initial review indicates that the post-acquisition performance has failed to meet pre-acquisition expectations or if any other previously unforeseen events or changes in circumstances indicate that the carrying values may not be recoverable."**

(c) paragraph 73 is deleted.

82 Paragraph 151 of the Guidance Notes to SSAP 21 'Accounting for leases and hire purchase contracts' refers to a "permanent diminution in value". The Guidance Notes were issued by the former Accounting Standards Committee of the CCAB and were not adopted by the Board. Nonetheless, it would be consistent with the above amendments to SSAPs and FRSs if the second sentence in paragraph 151 were deemed to be amended to

> "If the asset has suffered an impairment it should be written down to its recoverable amount."

ADOPTION OF FRS 11 BY THE BOARD

Financial Reporting Standard 11 – 'Impairment of Fixed Assets and Goodwill' was approved for issue by the ten members of the Accounting Standards Board.

Sir David Tweedie (Chairman)

Allan Cook (Technical Director)

David Allvey

Ian Brindle

Dr John Buchanan

John Coombe

Raymond Hinton

Huw Jones

Professor Geoffrey Whittington

Ken Wild

APPENDIX I:

DETERMINING PRE-TAX DISCOUNT RATES

1 The discount rate reflects the rate of return required on the assets being reviewed, not the way in which they have been financed. Hence it is not affected by any tax relief available on the cost of financing the asset or by any tax paid by the provider of finance.

2 The required pre-tax rate of return is simply the rate of return that will, after tax has been deducted, give the required post-tax rate of return. Because the tax consequence of different cash flows may be different, the pre-tax rate of return is not always the post-tax rate of return grossed up by a standard rate of tax.

3 The effect of discounting pre-tax cash flows at a pre-tax discount rate should be similar to the effect of discounting post-tax cash flows at a post-tax discount rate.

Example

An asset is required to generate a post-tax return of 14 per cent. If the asset cost £100, and generated all of its cash flows in one year's time, the required post-tax cash flows would be £114.

If tax was charged at 30 per cent, pre-tax cash flows of £120 would be required to generate the required post-tax cash flows of £114:

	£	£
Pre-tax cash flows		120
Tax at 30% of £120	(36)	
Allowance for cost of asset at 30%	30	
		(6)
		114

Thus the required pre-tax cash flows would be £120, making the required pre-tax rate of return 20 per cent.

The value assigned to the asset would be £100, whether calculated by discounting pre-tax cash flows (£120) by the pre-tax required rate of return (20 per cent) or by discounting post-tax cash flows (£114) by the post-tax required rate of return (14 per cent).

4 However, when an asset becomes impaired, the relationship between pre-tax and post-tax required rates of return may change. This is because, although future pre-tax cash flows reduce, the amount of future tax relief may not. This is taken into account by providing for deferred tax on any timing differences created by the recognition of the impairment loss, not by making any adjustment to the pre-tax discount rate.

Example

Suppose that in the previous example, £100 had been paid for the asset in the expectation that it would generate pre-tax cash flows of at least £120. However, circumstances then changed and the pre-tax cash flows were expected to halve to £60. The cash flows expected in one year's time would therefore be:

	£	£
Pre-tax cash flows		60
Tax at 30% of £60	(18)	
Allowance for cost of asset (£100 at 30%)	30	
		12
		72

Although the pre-tax cash flows have halved, the post-tax cash flows have not reduced so much. Thus discounting the pre-tax cash flows of £60 by 20 per cent (to give a value of £50) no longer produces the same value for the asset as would be achieved by discounting the post-tax cash flows of £72 by 14 per cent (to give a value of £63).

The difference is not eliminated by making any adjustment to the pre-tax rate of return to reflect the tax status of the asset under review. Rather it is eliminated by providing for deferred tax on the timing difference created by the recognition of the impairment loss:

	£
Impaired carrying value of asset (£60 discounted by 20%)	50
Deferred tax asset (impairment of £50 at 30%, discounted by 14%)	13*
Total amount recognised in respect of asset	63

* *Under SSAP 15, the deferred tax asset might not be recognised and would not be discounted.*

APPENDIX II:

NOTE ON LEGAL REQUIREMENTS

Great Britain

Impairment losses

1 Paragraph 19(1) of Schedule 4 to the Companies Act 1985 allows provisions for diminutions in value of fixed asset investments to be made and the amount to be included in respect of the fixed asset investment to be reduced accordingly. Any provisions that are not shown in the profit and loss account must be disclosed (either separately or in aggregate) in a note to the accounts.

2 Paragraph 19(2) of Schedule 4 requires provisions for diminution in value to be made in respect of any fixed asset that has diminished in value if the reduction in its value is expected to be permanent. The amount to be included in respect of the asset must be reduced accordingly. Any provisions that are not shown in the profit and loss account must be disclosed (either separately or in aggregate) in a note to the accounts.

3 Clearly it is a matter of judgement whether any diminution in value should be treated as permanent (although there must be reasonable grounds for making such a judgement), as indicated by the requirement, referred to again below, that any provision subsequently found not to be necessary has to be reversed.

4 In addition to references to diminutions in value in the paragraphs noted above, the Act allows for the revaluation downwards of fixed assets dealt with under the alternative accounting rules in paragraph 34 of Schedule 4.

5 The FRS concerns itself with impairment rather than permanent diminutions in value. Nevertheless, the distinction between permanent and temporary diminutions in value is inherently recognised in the FRS. A principle is established that impairments that are clearly due to consumption of economic benefits are charged to the profit and loss account. Any such loss is clearly a permanent loss. Other cases of impairment raise separate considerations.

6 Where a fixed asset is impaired, it will always be the case that both the value in use and the net realisable value will be below the carrying amount. Although this does not inevitably signify a loss that is permanent, it would be prudent in relation to fixed assets held at depreciated historical cost to regard such a loss as permanent and, despite any element of uncertainty, charge it to the profit and loss account. In the case of a revalued fixed asset, it would be reasonable to reflect the uncertainty of the permanence of any impairment by treating it as a reversal of any temporary increase in value previously recognised. Such an impairment would be dealt with through the statement of total recognised gains and losses (ie as a revaluation reserve movement). However, if the impairment results in a carrying value below depreciated historical cost, then, as in a pure historical cost context, it would be prudent and reasonable to treat that part of the impairment as being permanent and charge it to the profit and loss account.

Reversals of impairment losses

7 Paragraph 19(3) of Schedule 4 requires that where the reasons for which a provision was made have ceased to apply to any extent, the provision shall be written back to the extent that it is no longer necessary. Where any amounts written back are not shown in the profit and loss account, they must be disclosed (either separately or in aggregate) in a note to the accounts.

8 The FRS requires that, for tangible fixed assets, a reversal of an impairment loss should be recognised when the recoverable amount of an asset increases because of a change in economic conditions—the reason for the impairment was that the asset was not expected to generate sufficient returns to cover its carrying amount. Once it is expected to do so, the reason for the impairment ceases to apply.

9 The FRS explains that the increase in recoverable amount must arise from a change in economic conditions that results in a revised calculation of the recoverable amount. Increases in value in use may arise simply because of:

(a) the passage of time: as future cash inflows become closer, their discounted value increases; or

(b) the occurrence of forecast cash outflows: once the cash outflows are past, they are no longer part of the value in use calculation and value in use therefore increases.

The Board believes that these increases should not give rise to a write-back of the impairment loss because the reason for which the provision was made has not ceased to apply—all that has happened is that time has passed and the expected cash flows have occurred.

10 The Board has received legal advice that a reversal of an impairment loss on goodwill should be recognised only where an external event caused the recognition of the impairment loss in previous periods and subsequent external events clearly and demonstrably reverse the effects of that event in a way that was not foreseen in the original impairment calculations. The Board believes that, for the reasons set out in Appendix IV 'The development of the FRS', the same criterion should apply to intangible assets (except those that have a readily ascertainable market value).

Northern Ireland and the Republic of Ireland

11 The references to the equivalent statutory requirements in Northern Ireland and the Republic of Ireland are as follows:

Great Britain	*Northern Ireland*	*Republic of Ireland*
Schedule 4 to the Companies Act 1985:	Schedule 4 to the Companies (Northern Ireland) Order 1986:	The Schedule to the Companies (Amendment) Act 1986:
paragraph 19(1)	paragraph 19(1)	paragraph 7(1)
paragraph 19(2)	paragraph 19(2)	paragraph 7(2)
paragraph 19(3)	paragraph 19(3)	paragraph 7(3)
paragraph 34	paragraph 34	paragraph 22

APPENDIX III:

COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

1 The International Accounting Standards Committee approved its accounting standard IAS 36 'Impairment of Assets' in April 1998. The basic approach in the IAS is the same as that in the FRS: impairment is measured by comparing the carrying value of fixed assets and goodwill with the higher of net selling price (equivalent to net realisable value) and value in use. Value in use is calculated by discounting the cash flows expected to be generated from the assets.

2 The detailed requirements of the IAS are also very similar to those of the FRS. They differ insofar as:

(a) the FRS requires impairments of revalued assets that are clearly caused by the consumption of economic benefits to be recognised in the profit and loss account (paragraph 63). In contrast, the IAS requires such impairments to be recognised in the profit and loss account only to the extent that the loss exceeds the balance on the revaluation reserve relating to the assets in question.

(b) to be consistent with FRS 10 'Goodwill and Intangible Assets', the FRS aligns the treatment of intangible assets with that of goodwill, whereas the IAS treats intangibles as being more similar to tangible fixed assets. This has two consequences:

(i) the FRS allocates impairment losses in an income-generating unit first to goodwill, secondly to intangible assets and then to tangible fixed assets (paragraph 48). The IAS allocates impairment losses first to goodwill and then pro rata to intangible and tangible assets; and

(ii) the FRS restricts the recognition of reversals of impairment losses on intangible assets (except those with a readily ascertainable market value) to the same limited circumstances in which reversals of impairments of goodwill are recognised (paragraph 60). The IAS recognises reversals of impairments of intangible assets under the same conditions that apply to reversals of impairments of tangible fixed assets.

(c) the FRS has a general rule that in all but exceptional circumstances, longer-term cash flow projections should assume that within five years a steady or declining growth rate of no more than the relevant country average growth rate is achieved (paragraph 36). It requires disclosure if these assumptions are not made. The IAS has a similar general rule but:

- does not require disclosure if the assumptions are not made
- rather than restricting growth rates to those of the relevant country, restricts them to those of the relevant products, industry or country.

(d) if an acquired business has been merged with existing operations, the FRS requires any subsequent impairment to be allocated between the acquired goodwill and the goodwill in the existing operations at the time of merging the two businesses (paragraph 50). The IAS does not include this requirement.

(e) the FRS requires the accuracy of previous estimates of value in use to be monitored for five years following an impairment review (paragraph 54). Any impairment that should have been recognised at the time must be recognised in the current period unless it has since reversed, in which case its non-recognition in past years should be disclosed. The IAS does not include these requirements.

(f) The IAS requires the amounts recognised as impairment losses and reversals of impairment losses to be disclosed in more detail than does the FRS.

3 The rationale for including in the FRS each of the requirements mentioned above is addressed in Appendix IV 'The development of the FRS'.

APPENDIX IV:

THE DEVELOPMENT OF THE FRS

The need for a standard

1 It is accepted practice that a fixed asset should not be carried in financial statements at more than its recoverable amount, ie the higher of the amount for which it could be sold and the amount recoverable from its future use. However, there is little guidance on how recoverable amount should be measured and when impairment losses should be recognised. As a result, practice is inconsistent and perhaps some impairments may not be recognised on a timely basis.

2 The need for a standard on impairment is increased by the requirement in FRS 10 'Goodwill and Intangible Assets' that, where goodwill and intangible assets have a useful life in excess of twenty years (including those exceptional cases where the life is indefinite), the recoverable amount of the goodwill and intangible assets should be reviewed every year.

3 This FRS sets out a method for measuring and recognising impairment. In developing the FRS the Board has considered comments on its initial proposals that were set out in the Discussion Paper 'Impairment of Tangible Fixed Assets', on the related proposals on impairment set out in FRED 12 'Goodwill and Intangible Assets' and on FRED 15 'Impairment of Fixed Assets and Goodwill'.

Indications of impairment

4 Systematic depreciation ensures that the carrying amount of a fixed asset is reduced to reflect over its useful economic life any reduction in the asset's recoverable amount arising from consumption of economic benefits. A tangible fixed asset that is

depreciated in an appropriate manner is unlikely to become materially impaired unless events or changes in circumstances cause a sudden reduction in the estimate of the recoverable amount. Thus, where tangible fixed assets are depreciated, a requirement for an impairment review to be performed each period would be unnecessary and unduly onerous. The Board believes that, in such circumstances, impairment reviews are necessary only if events or changes in circumstances indicate that the carrying amount may not be recoverable. The additional occasions when impairment reviews are required for intangible assets and goodwill are set out and explained in FRS 10.

Measurement of impairment

Measurement by reference to recoverable amount

5 The FRS requires impairment to be measured by comparing the carrying amount of a fixed asset or income-generating unit with its recoverable amount. The recoverable amount is based on the cash flows that can be generated by the fixed asset or income-generating unit either by sale (net realisable value) or by continued use (value in use). When fixed assets or goodwill are written down to the higher of the amount that can be recovered through sale or continued use, they are recorded at their greatest value to the entity. If the entity chooses not to use or sell the fixed asset or income-generating unit so as to recover the greatest value possible, the loss from not doing so is properly recorded in the period in which the fixed asset or income-generating unit is sold when more could be recovered through use, or in the period(s) in which it is used when more could be recovered through sale.

6 The Board believes that this presents a faithful representation of the economic decisions that are made when a fixed asset or income-generating unit becomes impaired.

7 An alternative approach would be to measure impairment by reference to fair value, being the amount at which an asset or liability could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced or liquidation sale. This is the approach adopted by the US standard FAS 121 'Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of'. For many assets with a deep active market, fair value, net realisable value and value in use will not be materially different. Where there is no such market or where the entity uses the asset for a specific purpose not generally open to other participants in the market, there may well be a difference between net realisable value and value in use, and the notion of fair value is less well defined. It might, for example, be assumed that fair value is equal to net realisable value (subject to transaction costs) even if value in use is higher, but such an assumption does not reflect the fact that a willing seller would not dispose of the asset for much less than its value in use. Exactly what is the 'fair value' of the asset is open to question.

8 The Board believes that defining recoverable amount as the higher of net realisable value and value in use gives a more precise and clearer indication of the amount to which the asset should be written down and therefore prefers this terminology to the use of the term 'fair value'.

Constraints on estimates of value in use—growth rates and subsequent monitoring

9 The forecasts of future cash flows used to measure the value in use of a business are inevitably subjective. The FRS contains two key controls designed to reduce the risk of over-optimistic forecasting. First, it requires the longer-term projections of cash flows to assume a growth rate that does not normally exceed the long-term average growth rate for the country in which the business operates (paragraph 36). It allows higher rates to be used in the shorter-term forecasts, but states that only in exceptional (and disclosed) circumstances should these shorter-term forecasts extend beyond five years.

10 The Board recognises that, even in the longer term, growth rates in certain industries will exceed average growth rates for the country as a whole. However, it takes the view that this does not necessarily mean that individual businesses within such industries will grow as quickly: in the longer term, high growth industries may attract new businesses, reducing the opportunities for high growth rates in existing businesses. Hence, where an entity believes that it could justify using an industry growth rate for more than five years, it must disclose what it has done.

11 The second constraint placed on estimates of future cash flows is the requirement to monitor the accuracy of cash flow forecasts for the five years following an impairment review: any impairment that should have been recognised at the time must be recognised in the current period unless it has since reversed, in which case its non-recognition in past years should be disclosed. The aim of the disclosure requirement is primarily to ensure that cash flows are reliable: a

record of continually falling short of forecast cash flows will tend to cast doubt on the reliability of current estimates; and awareness that this would have to be disclosed will be an incentive to management to build its forecasts on realistic assumptions.

12 The Board views these two controls as important checks on the reliability of forecasts. They were proposed early on in the development of the FRS and included within the proposals in both the Discussion Paper and the subsequent FRED. They were accepted by most respondents.

Discounting

13 Discounting is a method of reflecting the time value of money and the effect of risk in the valuation of a stream of future cash flows. All rational economic decisions and, hence, all arm's length transactions reflect the time value of money and the effect of risk. Given that the Board's definition of recoverable amount is based on the economic decisions made when an impairment occurs, value in use must also reflect these factors. If not, value in use would not be measured on a consistent basis with net realisable value and cost (both of which are based on observable transactions and, hence, reflect the time value of money and the effect of risk). A comparison between carrying amount (based on cost), net realisable value and value in use would be meaningless.

14 The Board therefore believes that the cash flows on which value in use is based should either be discounted at a risk-adjusted rate, ie the rate of return that the market would expect on an equally risky investment, or should themselves be adjusted for risk before being discounted at a risk-free rate.

Tax

15 FRED 15 proposed that impairments should be measured on a post-tax basis and the tax element split out for presentation in the financial statements. An alternative approach, adopted by the FASB in FAS 121 and by IASC in IAS 36 'Impairment of Assets', is for value in use to be calculated by discounting the pre-tax cash flows at a pre-tax rate and any further tax consequences recognised by applying a tax standard. The reason behind the approach in FRED 15 was that it discounted the effect of any future capital allowances still to be received, whereas the present tax standard, SSAP 15, does not.

16 A slight majority of respondents to FRED 15 preferred the pre-tax approach, primarily because it was thought to be easier to apply. Given this view and the desirability of harmonisation with the USA and IASC, the Board has decided to change to a pre-tax approach. The question of discounting deferred tax assets and liabilities will be considered as part of the Board's project on deferred tax.

Measurement of impairment when acquired businesses are merged with existing operations

17 The FRS includes specific requirements regarding the measurement of an impairment arising after a purchased business has been merged with existing operations. It requires that any subsequent impairment of the combined business is allocated on a pro-rata basis between the (unrecognised) goodwill in the existing operations and the acquired goodwill. Had this requirement not been included, the effect would be that any impairment of the acquired goodwill would not be recognised unless, and to the extent that, the impairment of the combined business exceeded the value of the unrecognised goodwill at the time of merging.

18 IAS 36 does not include this requirement. Although IASC acknowledged that the requirement would be necessary to measure impairment accurately, it took the view that it would be a difficult requirement to apply in practice. The Board considered this argument, but retained the requirement in the FRS on the grounds that:

- without the requirement, impairment losses would be understated in the circumstances where the requirement applied.

- the absence of such a requirement would create an opportunity to avoid the recognition of impairment losses by treating an acquired business as having been merged with a large existing business.

- the requirement will not have to be applied universally: it will have to be applied only when performing an impairment review of purchased goodwill where the acquired business was merged with an existing business and the goodwill has become partly, but not wholly, impaired. Especially where goodwill is being amortised, these circumstances may not arise often.

Impairment of revalued fixed assets

19 The Board believes that, in principle, impairments of revalued fixed assets fall into two general groups—those that are clearly caused by a consumption of economic benefits and those caused by a general fall in prices. The first type is similar to depreciation and is treated as such, whereas the second type is more like a valuation adjustment that would fall to be recognised in the statement of total recognised gains and losses.

20 However, in many cases it is difficult to allocate an impairment to one or other group with certainty. In order to provide objectivity in the treatment of impairments of revalued fixed assets, the FRS requires that where there is doubt whether the impairment is caused by a reduction in the quantum of the service potential, the impairment loss should be recognised in the statement of total recognised gains and losses until the carrying amount of the asset reaches its depreciated historical cost. Any further impairment should be recognised in the profit and loss account.

21 Although this split between the statement of total recognised gains and losses and the profit and loss account where the type of impairment is unclear is necessarily arbitrary, it has the advantage of being consistent with IAS 16 (revised 1993) 'Property, Plant and Equipment' and IAS 36. It is also likely to be perceived as an equitable approach that does not penalise entities that revalue their fixed assets.

Reversal of past impairment losses

22 Companies legislation requires provisions for diminutions in value to be written back if the reasons for the provision have ceased to apply. The Board agrees with this principle but is aware that in some cases it will be difficult to distinguish between increases in the value of a fixed asset or income-generating unit that arise because the reasons for the impairment have ceased to apply and increases in value that arise for some other reason.

23 For tangible fixed assets and investments the Board believes it is acceptable for any increase in value that reverses a previous impairment to be recognised, as long as it results from changed economic conditions or the expected use of the asset and not simply the passage of time or the occurrence of forecast cash flows. After all, increases in value arising from changed economic conditions could be recognised by revaluing the assets.

24 In relation to intangible assets that cannot be revalued and goodwill, the Board does not wish to recognise increases in value attributable to the internal generation of intangible asset value or goodwill. Accordingly, the FRS allows recognition of reversals of past impairments of intangible assets and goodwill only where the increase in value can be clearly attributed to the unexpected reversal of an external event that caused the original impairment to be recognised.

Changes made to FRED 15

25 In the light of comments made by those responding to FRED 15, a number of changes have been made to its proposals. The most significant changes are that:

- investment properties are exempted from the requirements of the FRS. The treatment of investment properties is being considered further in the light of other Board projects and the international project on investment properties. The Board believes that, until this work is complete, it is appropriate to maintain the status quo as set out in SSAP 19 'Accounting for investment properties'.

- an entity's own shares held in an ESOP and shown as a fixed asset in the balance sheet under UITF Abstract 13 'Accounting for ESOP Trusts' are also exempt from the requirements of the FRS. The Board believes that an entity's own shares should be treated in a manner consistent with other investments, rather than as fixed assets. They will, therefore, be considered as part of the financial instruments project.

- the FRS requires a pre-tax rather than a post-tax approach to measuring impairment (see paragraphs 15 and 16 above).

- examples to clarify the principles underlying the identification of income-generating units have been added.

- an alternative to allocating central assets across income-generating units is allowed—the central assets may instead be tested for impairment by reviewing the combination of all the income-generating units to which they contribute.

- a requirement has been added (paragraph 38 of the FRS) that value in use should reflect the asset or income-generating unit as it exists at the balance sheet date and hence that in general the costs and benefits of future investment should not be included in the value in use calculation.

- explanation has been added regarding the circumstances in which the reversal of past impairment losses may be recognised.

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