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CFA LEARNING OUTCOMES DECODED

In our series *Learning Outcomes Decoded* we break down a single Learning Outcome Statement (LOS) from the CFA level 1 curriculum. This article is written by Cheryl Wu, CFA, CPA. Cheryl is the Content Developer of the CFA team at Princeton Review. She also works as a corporate development manager in the Energy and Utilities industry.

FINANCIAL STATEMENT ANALYSIS: LONG-LIVED ASSETS

LOS 1: Explain the impairment of property, plant, and equipment and intangible assets

LOS 2: Explain and evaluate how impairment, reevaluation, and derecognition of property, plant, and equipment and intangible assets affect financial statements and ratios

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This learning module discusses the different types of long-lived assets. It describes the choice of depreciation method and how it affects the financial statement and ratios. This LOS presents the IFRS and US GAAP standards on assessing impairment of property plant and equipment and other long-lived assets as well as the impact of impairment on the financial statement.

Impairment of tangible assets

For a tangible asset (such as property, plant and equipment) impairment is a reduction in value beyond normal depreciation. If impairment occurs, both IFRS and US GAAP require companies to write down the carrying value of the asset. An asset should be impaired when the carrying value exceeds the recoverable amount. IFRS and US GAAP address the process differently.

IFRS—To test if a tangible asset should be impaired, compare the carrying value of the asset to the *recoverable amount*. If the carrying value is greater, then the asset should be impaired.

Impairment loss = carrying amount of asset – recoverable amount of asset*

*Recoverable amount = higher of fair value less costs to sell or value in use**

**value in use is the present value of expected future cash flow

US GAAP—To test if a tangible asset should be impaired, compare the carrying value to the *total undiscounted future cash flows*. If the carrying value is greater, then the asset should be impaired.

Impairment loss = carrying value – fair value

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Timing of impairment tests

If the asset is subject to a depreciation or amortization schedule, then annual testing for impairment is not required. However, a test should be conducted whenever an indicator of impairment emerges, such as obsolescence or decline in demand due to technology advancement. For an asset with an indefinite life, impairment tests must be conducted *at least* on an annual basis.

Intangible assets with finite lives

An intangible asset that has a finite life (such as a patent) should be amortized across its projected lifespan. In addition, impairment tests should be conducted according to the same guidelines as the ones for tangible assets. At the end of each period management should assess whether a significant event suggests the need for a test. If impairment is called for, then follow the steps above to determine the amount.

Intangible assets with indefinite lives

Intangible assets that do not expire (such as goodwill or a trademark) are not amortized. They are carried on the balance sheet at historical cost but must be tested *at least* annually for impairment. Impairment loss is calculated as the amount by which the carrying value exceeds the fair value.

Impairment of long-lived assets held for sale

If an asset is reclassified from held for use to held for sale, then the asset is tested for impairment at the time of reclassification. If the carrying value exceeds the fair value less costs to sell, then an impairment loss is recognized, and the asset is written down to the latter.

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Reversal of Impairment

IFRS permits reversal of impairment, but only up to a maximum of previous carrying amount. This applies to both assets held for use and held for sale. US GAAP does not allow any reversal of impairment for assets held for use but does allow reversal of impairment for assets held for sale.

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PRACTICE QUESTION

Starlet Inc. is a producer of plastic packages. Due to technology advancements, the company is conducting an impairment test for some of the equipment it uses in its production process. The table below presents information for the equipment.

Carrying amount	$250,000
Fair value	$220,000
Costs to sell	$10,000
Undiscounted expected future cash flow	$230,000
Present value of expected future cash flows	$225,000

Under IFRS and US GAAP, the impairment loss recorded are

A. $30,000 under IFRS and $25,000 under US GAAP.

B. $25,000 under IFRS and $30,000 under US GAAP.

C. $30,000 under IFRS and $20,000 under US GAAP.

B is correct. The impairment loss under IFRS is calculated by comparing the carrying value to the recoverable amount. The recoverable amount is the higher of present value of expected future cash flows ($225,000) or fair value less costs to sell ($210,000). In this case, the recoverable amount is $225,000, so the impairment loss is $25,000 ($250,000 – 225,000 = 25,000). Under US GAAP, the carrying amount is compared to undiscounted expected future cash flows. In this case, the carrying amount is higher and the asset should be impaired. Impairment loss is the difference of carrying value less fair value, or $250,000 – 220,000 = $30,000.