IAS 36: Assessment of Cash-generating Units (CGUs) in a Production Facility with Multiple Production Lines When One of the Products Has a Declining Market Demand

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BACKGROUND

IAS 36 *Impairment of Assets* prescribes the procedures that an entity applies to ensure that its assets that are in the scope of the standard are carried at no more than their recoverable amount (i.e., the amount expected to be recovered through use or sale of the asset). If an asset is carried at more than its recoverable amount, the asset is impaired, and the entity is required to recognize an impairment loss. The requirements in the standard apply equally to an individual asset or a CGU. A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

An entity is required to determine the recoverable amount of an asset when there is an indication that an asset may be impaired. IAS 36 lists examples of indications of impairment but notes that the list is not exhaustive. It explicitly states an entity may identify other indications that an asset may be impaired, which would also trigger an impairment review.

The recoverable amount of an asset or CGU is the higher of its fair value less costs of disposal (FVLCD) and its value in use. If the recoverable amount of an asset or CGU is less than its carrying amount, the carrying amount of the asset or CGU is reduced to its recoverable amount.

If impairment testing is required, the recoverable amount is estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity determines the recoverable amount of the CGU to which the asset belongs. Paragraph 67 of IAS 36 states that:

The recoverable amount of an individual asset cannot be determined if:

- the asset's value in use cannot be estimated to be close to its fair value less costs of disposal (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and
- the asset does not generate cash inflows that are largely independent of those from other assets.

In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit.

Paragraph 102 of IAS 36 requires an entity to identify all corporate assets that relate to a CGU that is under review. Corporate assets are assets other than goodwill that contribute to the future cash flows of both the CGU under review and other CGUs. Paragraph 100 of IAS 36 states that:

Corporate assets include group or divisional assets such as the building of a headquarters or a division of the entity, EDP equipment or a research centre. The structure of an entity determines whether an asset meets this Standard's definition of corporate assets for a particular cash-generating unit. The distinctive characteristics of corporate assets are that they do not generate cash inflows independently of other assets or groups of assets and their carrying amount cannot be fully attributed to the cash-generating unit under review.

If a portion of the carrying amount of a corporate asset can be allocated on a reasonable and consistent basis to the CGU, the entity compares the carrying amount of the unit, including the portion of the carrying amount of the corporate asset allocated to the unit, with its recoverable amount.

Identifying an asset's CGU, and the level at which an impairment test should be performed, might involve judgment and careful consideration of the facts and circumstances. Interested and affected parties may observe that entities are facing changes in their economic environments (e.g., technological advancements) or natural environments (e.g., climate-related matters) that might impact companies' business models, cash flows, and financial performance. Consequently, such changes might give rise to triggers leading to the requirement to perform an impairment test. Entities should carefully consider the level at which an impairment test should be performed, along with other related accounting implications on how to perform such an impairment test.

Fact Pattern for Issue 1 and Issue 2

- Manufacturing Company X owns a factory that produces two distinct products (Product A and Product B). These products are not interdependent; they are sold to different customers and generate separate cash inflows.
- The factory consists of three key components:
  - a piece of land that is not amortized;
  - a building with a remaining useful life of 20 years; and
  - two separate production lines, one for Product A (Production Line A) and one for Product B (Production Line B), each with a remaining useful life of eight years.
- Internal management reporting is organized to monitor the operations and performance of each product individually.
- Company X's management notices a sharp decline in the market demand for Product B. This is considered an indication of impairment, suggesting that the assets used to produce Product B may be at risk of being impaired.
- Neither of the production lines can be converted to produce other products. However, they can be dismantled and reassembled at another location or factory, though management does not view this as a viable option for Production Line B.

- The decline in market demand for Product B is part of a broader trend, reflecting significant adverse changes in the market and economic environment in which Product B is sold. This decline is not due to factors specific to the production line or factory itself.
- The fair values of the land and building exceed their carrying values.
- The observed market decline for Product B is an indication of impairment, which serves as a trigger for impairment testing. Company X must determine the appropriate level at which to conduct the impairment test (asset-level or CGU-level).

Issue 1: At what level should the impairment test be performed?

Analysis

View 1A – Production Line B is a CGU, and the impairment test should be performed at the level of Production Line B

Proponents of this view think that Production Line B is a CGU because it is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets (i.e., cash inflows from Product B are separate from cash inflows from Product A as these products are not interdependent). They note that designating Production Line B as a CGU is consistent with paragraph 69 of IAS 36, which refers to a product line as an example of a CGU. They also note that there are examples in the standard and related guidance where the CGU is an asset or group of assets at a level below the entire manufacturing site:

- In the example following paragraph 107 of IAS 36, a machine in a production facility is damaged and is not working as well. The machine's FVLCD is less than its carrying amount. However, the example states that the machine does not generate independent cash inflows. Therefore, the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets is the production line to which the machine belongs.
- In Illustrative Example 6 of IAS 36, a single machine is identified as the CGU being tested for impairment (Illustrative Examples accompany, but are not part of, the standard).

View 1B – Production Line B cannot be a CGU, hence the impairment test should be performed at the level of the entire factory

Proponents of this view note that the definition of a "CGU" focuses on a company's sources of revenue and how assets are used to generate those revenues. They note that Production Line B does not generate cash inflows on its own because manufacturing Product B depends on the factory's building and the land underneath the building. Therefore, they think that Production Line A and Production Line B (i.e., the entire factory) is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets. Accordingly, they think the impairment test for Production Line B must be performed at the level of the entire factory.

The Group's Discussion

The Group agreed with View 1A. They thought the cash inflows generated by Product A are independent of those generated by Product B because the products are sold to different customers, they are not interdependent, and management tracks their performance separately. Some Group members also commented that the two production lines are separately impacted by market forces, leading to an indication of impairment for only one of them. They thought that while not determinative on its own, this was consistent with the analysis that they are separate CGUs. One Group member thought that treating the entire factory as a single CGU might cause the value of Production Line A to shield Production Line B from impairment, which would be inconsistent with the objective of IAS 36. Another Group member noted that the identification of CGUs is often challenging and requires significant judgment. They noted that the fact pattern in this paper was more straightforward than those often seen in practice, leading to a more straightforward conclusion.

Issue 2: Depending on the view selected in Issue 1, what are the implications for conducting the impairment test in terms of determining future cash flows and allocating corporate assets, if any?

Analysis

<u>If View 1A is selected in Issue 1 (i.e., testing Production Line B as a CGU)</u>

If Production Line B is a CGU, future cash flows used in the impairment test should be projected over its remaining useful life in line with paragraph 33 of IAS 36. Its remaining useful life is eight years unless management plans to discontinue its use before that. The land and building are corporate assets because they contribute to the future cash inflows of Production Line A and Production Line B. In accordance with paragraph 102 of IAS 36, when assessing the potential impairment of Production Line B, a portion of the carrying amount of the land and building should be allocated to Production Line B, if this allocation can be done on a reasonable and consistent basis.

View 2A(i) – Allocate land and building to the CGU on a reasonable and consistent basis

Proponents of this view think that the carrying amounts of the land and building can be allocated to Production Line B on a reasonable and consistent basis. This is based on the fact that there are two production lines (and therefore two separate CGUs within Company X), the products are not interdependent and management of Company X monitors operations of the products separately. Therefore, they think that management could allocate the carrying value of the land and building to the CGU based on revenues, the relative carrying value of the CGU's assets, or on another reasonable basis.

View 2A(ii) – Allocate land and building on a reasonable and consistent basis and factor in proceeds of disposal/residual value of these corporate assets at the end of the projection period

Proponents of this view agree with the allocation method outlined in View 2A(i). However, they also note that the useful lives of the land and building are considerably longer than the useful life of the production line. Therefore, they think that the cash flows of the CGU for Production Line B should also take into account an allocation of the proceeds of disposal or residual value of the land and building at the end of eight years (even if management does not intend to dispose of these assets). Otherwise, they think this would result in an over recognition of impairment losses.

View 2A(iii) – The land and building should be tested separately because they cannot be allocated on a reasonable and consistent basis

Proponents of this view think that the carrying amounts of the land and building cannot be allocated to the two separate CGUs (Production Lines A and B) on a reasonable and consistent basis. This is primarily because the useful lives of the land and building extend for a significantly longer period than those of the production lines (e.g., the useful life of the land is indefinite). Company X likely anticipates that there will be other future products brought to market by the entity, and therefore there will be other future CGUs to which the land and building can contribute. However, since these future CGUs are undetermined at this time, there would be no reasonable basis to allocate the corporate assets (i.e., the land and building) among the existing or potential future CGUs.

If View 1B is selected in Issue 1 (i.e., testing the entire factory as a CGU)

If all the elements of Company X's factory (i.e., Production Lines A and B, the building, and the land) constitute a single CGU, the entity should apply paragraph 49 of IAS 36 when determining the value in use of the CGU. Paragraph 49 specifies that, "when a cash-generating unit consists of assets with different estimated useful lives, all of which are essential to the ongoing operation of the unit, the replacement of assets with shorter lives is considered to be part of the day-to-day servicing of the unit when estimating the future cash flows associated with the unit." Similarly, when determining the FVLCD of the CGU, Company X should consider the perspective of a market participant, who would likely consider the replacement of assets with shorter useful lives when estimating the future cash flows.

View 2B(i) – Future cash flows of the facility should be projected into perpetuity

Proponents of this view think that all the assets, including the land, are considered essential to the CGU's ongoing operation as per paragraph 49 of IAS 36. Under this view, the value in use should be determined by extrapolating the facility's future cash flows into perpetuity because the land has an indefinite useful life.

View 2B(ii) – Future cash flows of the facility should factor in the proceeds of the disposal/residual value of the land and building

Proponents of this view think that the production line is the main "essential operating asset." Therefore, they think that cash inflows should be projected for the remaining useful life of the production line (i.e., eight years). They also think the residual value of the land and building at the end of eight years should be factored into the CGU's cash flow projections (even if management does not intend to dispose of these assets).

The Group's Discussion

Since the Group unanimously agreed that each production line is a CGU, it only considered Views 2A(i) to 2A(iii) when discussing Issue 2. The Group did not discuss Views 2B(i) and 2B(ii).

Some Group members agreed with View 2A(i). They thought that the land and building are corporate assets and the carrying amounts of the land and building should be allocated to the CGUs on the basis that such allocation can be made on a reasonable and consistent basis in accordance with paragraph 102(a) of IAS 36. They also thought that because Production Line B is considered a separate CGU, the projected future cash flows should be limited to its remaining useful life (i.e., eight years or less if management plans to discontinue its use before then) and the residual value of the land and building should not be factored into its recoverable amount.

Some Group members supported View 2A(ii) as they thought the carrying value of the land and building should be allocated to the CGUs because this can be done on a reasonable and consistent basis. However, they thought that excluding the residual value of the land and building from the recoverable amount of Production Line B (the CGU) would unfairly burden the CGU, leading to an over recognition of impairment losses. The Group members thought that paragraph 39(c) of IAS 36 should be considered. This paragraph notes that net cash flows from disposal of the assets should be included in the estimate of future cash flows. Even though the land and building may not be sold at the end of the eight-year cash flow projection period, they will no longer be a supporting asset for the CGU; therefore, their disposal value/residual value at that time should be considered in the estimate of cash flows.

In addition to the views expressed in the paper, a significant number of Group members noted that they would support a view in-between Views 2A(i) and 2A(ii). They agree with View 2A(ii) that allocating the full carrying value of the land and building to the CGUs without any residual value would unfairly burden the CGU. However, these Group members noted that the land and building fair values are in excess of their carrying value and that including an allocation of the residual value of the land and building in the recoverable amount of the CGU might inappropriately shield the CGU from impairment losses. Therefore, these Group members thought that judgment would need to be applied to determine an appropriate basis for allocating the residual values of the land and building between the two CGUs to avoid any inappropriate shielding.

None of the Group members agreed with View 2A(iii) because they thought the carrying value of the land and building can be allocated to the CGUs on a reasonable and consistent basis. However, some Group members noted that under alternative fact patterns entities might consider allocating only a portion of the carrying value of the corporate assets to the CGUs. For example, one Group member raised an example when a significant portion of the entity's land is idle (i.e., not being used). They thought in this scenario the entity might consider only allocating a portion of the carrying value of the land to the CGUs when assessing Production Line B for impairment.

Fact Pattern for Issue 3

- Assume the same facts as Fact Pattern for Issue 1 and Issue 2, except the factory only comprises Production Line B.

Issue 3: Do the land and building meet the definition of a "corporate asset"?

Analysis

View 3A – Yes, the land and building meet the definition of corporate assets

Proponents of this view note that the land and building meet the definition of "corporate assets". This is because they have longer remaining useful lives than Production Line B and they will contribute over time to future cash inflows of Production Line B and other CGUs that will replace Production Line B once it is no longer in use (or which will be created as new products are brought to market during the extended useful life period). When testing Production Line B for impairment, a portion of the carrying amount of the land and building should be allocated to the CGU, if it can be done so on a reasonable and consistent basis.

View 3B – No, the land and building do not meet the definition of corporate assets, and they should be tested separately

Proponents of this view note that because there is only one production line, the land and building do not currently contribute to the future cash flows of more than one CGU. Therefore, they do not meet the definition of corporate assets in paragraph 6 of IAS 36. Proponents of View 3B think that, consistent with Issue 1, the CGU is at the production line level. However, in this fact pattern as the land and building do not meet the definition of corporate assets and do not contribute to the future cash inflows of any other CGUs, they should be tested for impairment as individual assets if their FVLCD falls below their carrying amounts based on paragraph 22 of IAS 36.

View 3C: No, the land and building do not meet the definition of corporate assets, and they should be tested for impairment as part of a single CGU

Similar to View 3B, as there is only one production line, the land and building do not meet the definition of a corporate asset because they do not currently contribute to the future cash flows of more than one CGU. As these assets do not generate independent cash flows, they are to be tested as part of a single CGU comprising Production Line B, the land, and the building, in accordance with paragraph 67 of IAS 36.

The Group's Discussion

Most Group members agreed with View 3C. They thought the land and building are part of the CGU because they do not generate cash flows independent of the production line. They also noted the land and building are essential components of the CGU because the production line requires them to function. One Group member mentioned that the declining market demand for Product B might trigger the entity to reassess the depreciation rate of the assets in the production line. However, they emphasized that even with an accelerated depreciation rate for certain assets, the entire production facility, including the land and building, remains a CGU.

One Group member supported View 3B because they thought the fair value of the land and building in the CGU might inappropriately shield it from impairment losses. However, other Group members noted that the economic shielding from impairment losses provided by the fair value of the land and building is a result of applying the requirements in the standard.

Another Group member said their view on Issue 3 depends on when management intends to dismantle the production line. If management intends to discontinue sales of Product B soon, they think that management should test the production line for impairment separately from the land and building (i.e., View 3B). Conversely, if management intends to continue production of Product B for the remaining eight-year useful life of the production line, they think all the assets should be tested for impairment as part of a single CGU (i.e., View 3C). They noted that this view aligns with the example following paragraph 107 in IAS 36 where the level at which impairment is assessed depends on when management intends to dismantle/dispose of the asset.

None of the Group members agreed with View 3A. They noted corporate assets contribute to the future cash flows of more than one CGU. Since there is only one CGU in this fact pattern, the land and building cannot meet the definition of "corporate assets".

Overall, the Group's discussion raised awareness of some key accounting considerations for impairment tests, such as identifying CGUs, allocating corporate assets, and determining the recoverable amount of the assets being tested. The Group noted that the IASB is currently undertaking a project entitled "Business Combinations – Disclosures, Goodwill and Impairment," which aims to improve the application of the impairment test for CGUs including those containing goodwill. The Group recommended that the AcSB monitor the outcome of this project and consider whether additional guidance is needed on the allocation of assets when performing impairment tests.