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Regulation of the Ministry of Finance on the
“Establishment of the Guidelines of the Accounting Standards Board”
Note 5
In force from: 01.01.2019
Applicable to the accounting periods, starting on 01.01.2018 or later.

ASBG 5 – PROPERTY, PLANT AND EQUIPMENT AND INTANGIBLE ASSETS

TABLE OF CONTENTS	**clauses**

OBJECTIVE AND BASIS FOR PREPARARTION

1. The objective of this guideline ASBG 5 "*Property, Plant and Equipment and Intangible Assets*" of the Accounting Standards Board is to prescribe rules for the accounting for property, plant and equipment and intangible assets in the financial statements prepared in accordance with the Estonian financial reporting standard (hereinafter also *the financial statement*). Estonian financial reporting standard is a body of financial reporting requirements directed at the public and based on the internationally accepted accounting and reporting principles, which principal requirements are established by the Accounting Act and which is specified by a regulation of the minister responsible for the area established on the basis of subsection 34 (4) of the Accounting Act (hereinafter *guideline of the Standards Board* or for short *ASBG*).

2. ASBG 5 takes into consideration the accounting policies prescribed in several sections of IFRS for SMEs, including 17 "*Property, Plant and Equipment*", 18 "*Intangible Assets other than Goodwill*", 19 "*Business Combinations and Goodwill*", 25 "*Borrowing Costs*" and 27 "*Impairment of Assets*", and concepts defined in section 2 "*Concepts and Pervasive Principles*" and "*Glossary of Terms*". The guideline contains references to the specific paragraphs of IFRS for SMEs that the requirements of the guideline are based on. The comparison of ASBG 5 with IFRS for SMEs is presented in clauses 79-82. In areas where ASBG 5 does not specify a particular accounting policy but that are covered by IFRS for SMEs, it is recommended to abide by the accounting policy described in IFRS for SMEs.

SCOPE

3. ***ASBG 5 "Property, Plant and Equipment and Intangible Assets" shall be applied to accounting for and reporting of items of property, plant and equipment and intangible assets in the financial statements.***

4. ASBG 5 shall neither be used for the accounting for investment property (see ASBG 6 "*Investment Property*") nor for biological assets related to agricultural activity (see ASBG 7 "*Biological Assets*").

5. In addition to this guideline, the rules prescribed in ASBG 9 "*Accounting for Leases*" shall be used for accounting for leased non-current assets. The rules prescribed in guidelines ASBG 12 "*Government Grants*" and ASBG 11 "*Business Combinations and Recognition of Subsidiaries and Associates*" shall be used for accounting for the cost of non-current assets acquired through government grants or in business combinations, respectively.

DEFINITIONS

6. ***The following terms are used in this guideline with the meanings specified:***

<u>Property, plant and equipment</u> are tangible assets that an entity uses for the production of goods, rendering of services, for rental to others, or for administrative purposes (a non-

profit accounting entity for attaining the goals set for it) and that are expected to be used during a period exceeding one year. (IFRS for SMEs 17.2).

***Intangible assets** are non-monetary assets without physical substance that are clearly identifiable from other assets. (IFRS for SMEs 18.2).*

***Intangible non-current assets** are intangible assets that the entity expects to use during more than one year.*

***Acquisition cost** is the fair value of cash or non-monetary consideration paid to acquire an asset at the time of its acquisition and the fair value of cash or non-monetary consideration received upon assuming a liability. (IFRS for SMEs 2.34 (a)).*

***Residual value** is the amount that an entity would currently obtain from disposal of the asset (less the costs to sell), if the asset were already of the age and in the condition expected at the end of its useful life. (IFRS for SMEs Glossary of Terms).*

***Depreciable amount** is the cost of an asset less its residual value. (IFRS for SMEs Glossary of Terms).*

***Depreciation** is the systematic allocation of the depreciable amount of an asset over its useful life. (IFRS for SMEs Glossary of Terms).*

***Useful life** is:*

> ***(a) the period over which an asset is expected to be used by an entity; or*(b) the number of production units (or other similar units) expected to be obtained from using the asset by an entity. *(IFRS for SMEs Glossary of Terms).***

***Accumulated depreciation** is the depreciable amount of an asset already depreciated into an expense (synonymous with the definition "accumulated amortisation").*

***Borrowing costs** are interest expenses calculated on the basis of the effective interest rate method as described in ASBG 3, "Financial Instruments" and other costs incurred in connection with using external funds. (IFRS for SMEs 25.1).*

***Carrying amount** is the net amount at which an asset is carried in the balance sheet (taking into consideration accumulated depreciation and any impairment).*

***Fair value** is the amount for which an asset could be exchanged or a liability settled in a transaction between knowledgeable, willing and independent parties in an arm's length transaction. (IFRS for SMEs 2.34 (b)).*

***Costs to sell** incremental costs that are attributable to the disposal of a cash-generating unit or assets.*

***Value in use** is the present value of estimated future cash flows expected to arise from the use of an asset and from the disposal at the end of its useful life. (IFRS for SMEs 27.15).*

***Recoverable amount** is the higher of the fair value of an asset (less costs to sell) and its value in use. (IFRS for SMEs 27.11).*

***A cash-generating unit* is the smallest identifiable group of assets that generates cash flows that are largely independent of the cash flows from other assets. (IFRS for SMEs 27.8).**

7. The definition of property, plant and equipment also includes land and buildings (or a part of a building) and the rights associated with them (e.g., the right of superficies, usufruct) that the entity uses in its operations (whether for production, provision of services or as an administrative building). The definition of property, plant and equipment does not include land and buildings that the entity holds for the generation of rental income or the increase in the market value and that are not used in its operations (see ASBG 6 "Investment Property"). The right of superficies and usufruct, paid for in periodic instalments, shall be recognised as operating or finance lease based on clause 15 of ASBG 9.

8. Intangible non-current assets include also computer software, trademarks, patents, licenses, user rights, customer lists, quotas and other similar assets. In certain cases, an asset may contain the elements of both property, plant and equipment as well as intangible non-current assets. In this case, the asset will be classified based on what characteristics it meets more. For example, computer software is classified as property, plant and equipment if it is an integral part of a specific hardware. When using the software is independent of the hardware, it is classified as an intangible non-current asset.

9. Based on the materiality principle, low-value assets are not capitalised as non-current assets in the balance sheet even if their useful lives exceed one year. In its accounting policies and procedures, an entity shall set the minimum cost level, above which the assets shall be capitalised as non-current assets and below which expensed at the time they are taken into use. A change in the minimum level shall be considered a change in accounting estimates in accordance with ASBG 1 "General Principles for Preparing the Financial Statements". Low-value assets with a long useful life may be accounted for off-balance sheet.

10. Spare parts are usually carried as inventory and recognised in profit or loss as consumed. Major spare parts are also property, plant and equipment when an entity expects to use them during more than one year or if they can be used only in connection with a specific item of property, plant and equipment. (IFRS for SMEs 17.5).

ACCOUNTING POLICIES FOR PROPERTY, PLANT AND EQUIPMENT

Initial Recognition

11. ***An item of property, plant and equipment that meets the criteria for recognition as an asset in the balance sheet (see ASBG 1, clauses 10-16) shall initially be recognised at cost which comprises (IFRS for SMEs 17.10):***

(a) ***its purchase price (including import duties and other non-refundable taxes);***

(b) ***any costs directly attributable to its acquisition; and***

(c) ***the present value of future estimated costs of dismantling an asset and restoring its site of location (e.g. recultivation of land) if its recognition complies with the policies for setting up a provision as described in guideline ASBG 8 "Provisions, Contingent Liabilities and Contingent Assets".***

12. Directly attributable costs are those that are necessary for bringing the asset to its operating condition and location, including (IFRS for SMEs 17.10):

(a) fees of designing an asset and other similar fees;
(b) wages and salaries and related taxes paid to the employees in connection with the construction of an asset;
(c) materials and tools used in the construction of an asset;
(d) depreciation of non-current assets used in the construction;
(e) transport costs related to bringing an asset to its operating location;
(f) costs related to the preparation of the site and installation of an asset;
(g) costs of testing an asset (less income from selling any items produced during the testing); and
(h) any service fees directly related to the acquisition of an asset (e.g. notary fees, state fees).

13. If the payment for property, plant and equipment is deferred beyond normal credit terms, the present value of the consideration payable shall be considered the cost of the asset. The difference between the nominal value and the present value is recognised as an interest expense over the period of credit. (IFRS for SMEs 17.13).

14. The following expenses shall not be capitalised into the cost of property, plant and equipment (IFRS for SMEs 17.11):

(a) expenses related to opening a new facility;
(b) expenses related to introducing a new product or service (including costs of advertising);
(c) expenses related to conducting business in a new location or with a new customer segment (including costs of staff training);
(d) administration and other general overhead expenses;
(e) borrowing costs (except if the entity applies the alternative accounting policy, permitted in clause 15 of this guideline). (IFRS for SMEs 25.2).

15. ***If an item of property, plant and equipment is produced over a longer period of time and it is financed with a loan or other debt instrument, the borrowing costs directly attributable to the production of the item of property can be capitalised in the acquisition cost of the given item.***

16. Borrowing costs include interests calculated at effective interest rate method (as described in ASBG 3 "*Financial Instruments*"), on loans, finance lease agreements and other debt instruments taken to finance the production of the item of property. Borrowing costs can be capitalised only as of the moment, when the incremental borrowing costs attributable to the production of the item as well as the costs for the production of item were incurred. Capitalisation of borrowing costs shall end as of the moment when the item is ready or its production has been terminated. Loan capital costs are capitalised only, if their impact on the cost of item is significant.

17. ***If an asset is acquired through a non-monetary transaction (barter transaction) in exchange for another asset, the cost of the asset acquired is deemed to be its fair value, except when:***

(a) the fair value of items to be exchanged cannot be determined reliably; or

> ***(b) the exchange transaction lacks commercial substance (for example, a transaction which is not based on business logic and is aimed at obtaining certain financial results between related parties).***

In the above-mentioned examples (a) and (b), the carrying amount of the asset given up is considered to be the cost of the asset received. (IFRS for SMEs 17.14, 18.13).

Example 1 – Acquisition of asset through a non-monetary exchange transaction			
An entity exchanges a car with the carrying amount of 5 000 euros and the estimated market value of 8 000 euros for a tractor (the estimated market value is also 8 000 euros). Assuming that the transaction occurred between independent parties under market conditions, the cost of the asset received is considered to be 8 000 euros.			
Entries upon recording the transaction:			
D	Property, plant and equipment (tractor)	8,000	
C	Property, plant and equipment (car)	5,000	
C	Profit from disposal of property, plant and equipment (car)	3,000	

18. ***If the major components of an item of property, plant and equipment have significantly different useful lives, these components shall be recognised initially as separate items of property, plant and equipment and separate depreciation rates shall be assigned to them depending on their useful lives. (IFRS for SMEs 17.16).***

19. The materiality principle shall be used when allocating cost to separate components, i.e. components with immaterial acquisition cost need not be recognised separately even if they have different useful lives.

Example 2 – Allocating the cost between components			
An entity acquires a production line with a cost of 1,000,000 euros. The estimated useful life of the production line is at least ten years, but it consists of certain parts that need to be replaced every three years. The estimated cost of replaceable parts is 100,000 euros. Upon acquisition, the entity recognises the replaceable parts as separate items of property, plant and equipment:			
D	Property, plant and equipment (production line – main part; to be depreciated over 10 years)	900,000	
D	Property, plant and equipment (production line – exchangeable parts; over 3 years)	100,000	
C	Cash	1,000,000	
In three years' time, the carrying amount of exchangeable parts will be expensed (in case it has not yet been fully depreciated) and the cost of new parts (which may be more or less than 100,000 thousand euros) will be recognised as a new item of property, plant and equipment.			

20. The determination of the cost of property, plant and equipment received through government grants is based on ASBG 12 "*Government Grants*". The determination of the cost of property, plant and equipment acquired through a finance lease is based on ASBG 9 "*Accounting for Leases*". The determination of the cost of property, plant and equipment acquired thorough business combinations is based on ASBG 11 "*Business Combinations and Accounting for Subsidiaries and Associates*".

Subsequent Measurement

21. ***In the balance sheet, an item of property, plant and equipment shall be carried at cost less accumulated depreciation and any impairment losses (IFRS for SMEs 17.15, 2.49).***

22. The depreciable part of items of property, plant and equipment shall be expensed during the useful life of the item. Exceptions are items with an unlimited useful life (e.g. land, works of art with sustained value, museum exhibits and books) that are not depreciated. Works of art acquired for designing purposes that have no sustained value as well as museum exhibits and books that need to be replaced after a certain time period, are depreciated during their useful lives.

23. ***The depreciation method selected shall systematically reflect the pattern in which the asset's economic benefits are expected to be consumed by an entity over the asset's useful life (which might not coincide with the decrease of the value of the asset over time). (IFRS for SMEs 17.22).***

24. Depreciation needs to express the use of an asset during its useful life and not necessarily the change in its value. Hence the objective of selecting depreciation methods and rates is not to keep the carrying amount of an asset as close as possible to its market value but to reflect the asset's use as fairly as possible.

25. In practice, the straight-line method is often used for depreciating items of property, plant and equipment. The use of other methods (e.g. *diminishing balance method* and the *units of production method*) should also be considered if they reflect more objectively the allocation of expected future economic benefits over the useful life of the asset. (IFRS for SMEs 17.22).

<u>Example 3 – Choosing the depreciation method</u>

An entity acquires a piece of equipment (with cost of 100,000 euros) which according to the manufacturer should work for 10,000 operating hours, regardless of the time period over which the equipment is used.

It is acceptable that the entity uses the actual operating time as the basis for determining its deprecation. For example, if the equipment operated for 1,600 hours (16% of its total useful life) in year 1, and 2,400 hours (24% of its total useful life) in year 2, the recognised depreciation charge is 16,000 euros in year 1 and 24,000 euros in year 2.

26. An entity shall consider all the following factors in determining the useful life of an asset (IFRS for SMEs 17.21):

(a) the expected usage of the asset based on the asset's expected capacity or productivity;
(b) expected physical wear and tear;
(c) technical or commercial obsolescence, arising from changes in the entity's product portfolio and market demand; and

(d) legal or other limits on the use of the asset, such as the expiry dates of related leases.

27. In case the residual value of an asset is insignificantly low, it may be assumed to be zero. In case of items with a significant residual value, only the depreciable portion of the difference between the cost and the residual value shall be depreciated into an expense over their useful lives. (IFRS for SMEs 17.18) Depreciation of an asset ceases when its residual value exceeds its carrying amount. Depreciation of an asset begins again as of the moment its residual value has dropped below its carrying amount.

28. Generally, every accounting entity sets out in its accounting policies and procedures the depreciation methods and the ranges for depreciation rates that shall generally be used for depreciating its non-current assets. The same depreciation rates may be applied to the whole asset class of individually less significant or standard items of property, plant and equipment. The depreciation rates for individually significant or non-standard items shall be assigned to each item of property, plant and equipment separately, based on the useful life of the specific item.

29. Depreciation of an asset begins at the time when it is available for use (i.e. when it is in the condition and location intended by management) and it is continued until the full depreciation of the depreciable amount or until it is retired from active use. The depreciation of an asset temporarily retired shall not be ceased. (IFRS for SMEs 17.20).

30. The following factors may indicate that the residual value or useful life of an asset has changed compared to the previous reporting date:

(a) a change in how an asset is used;
(b) significant unexpected wear and tear;
(c) technological progress;
(d) changes in market prices;
(e) indicators listed in clause 54 regarding the potential impairment of asset.

If such indicators are present, an entity shall review its previous estimates regarding depreciation rates, depreciation methods and estimated residual values used and change them if necessary. The effect of the change in the depreciation rate, depreciation method or residual value shall be accounted for as a change in accounting estimates in accordance with ASBG 1 (i.e. in the current and following accounting periods, not retrospectively). (IFRS for SMEs 17.19, 17.23, 18.24, 27.10).

<u>Example 4 – Change in accounting estimates regarding the useful life of asset</u>

An entity owns certain facilities with the cost of 100,000 euros that are being depreciated over 20 years (the depreciation rate of 5%). By the reporting date, the carrying amount of these facilities is 50,000 euros and the remaining useful life is 10 years. Immediately prior to the reporting date, a decision was made to replace these facilities in five years.

Pursuant to this decision, the remaining life of the facilities shall be changed to five years and the carrying amount will be depreciated into an expense over five years (10,000 euros a year). The depreciation charge of prior periods shall not be changed.

The fact that the facilities are planned to be replaced in five years may refer to their

impairment. To determine whether the facilities should be written down in addition to changing their depreciation period, an impairment test needs to be carried out (see clauses 50-75).

Improvements, Repairs and Maintenance

31. Costs related to subsequent improvements shall be added to the cost of property, plant and equipment only if they meet the definition of property, plant and equipment and the criteria for recognising assets in the balance sheet (incl. expected participation in the provision of future economic benefits). Costs related to ongoing maintenance and repairs shall be charged to period expenses. (IFRS for SMEs 17.7).

32. In case a part of an item of property, plant and equipment is replaced, the cost of the new part shall be added to the cost of the item if it meets the definition of non-current assets and the criteria for recognising assets in the balance sheet. The replaceable part shall be written off the balance sheet even if it had not been accounted for as a separate component. If the initial cost (and hence the current carrying amount) of the replaceable part is not known, it may be estimated based on the cost of this part today less estimated depreciation. (IFRS for SMEs 17.6, 17.7).

Example 5 – Recognition of change in the component in accounting for property, plant and equipment
The roof (cost of 70,000 euros) and the floor (cost of 20,000 euros) of a dilapidated building are replaced and the walls are repainted (cost of 2,000 euros). The estimated useful life of the new roof is 30 years (the same as the remaining useful life of the building). The estimated useful life of the new floor is ten years after which the floor needs to be replaced again. The walls are repainted, when necessary, every 1-3 years.
Both the roof and the floor meet the definition of property, plant and equipment as well as the criteria for recognising assets in the balance sheet, because:
(a) they are expected to participate in the provision of future economic benefits;
(b) their cost can be determined reliably; and
(c) they will be used for more than one year.
It is known that the carrying amount of the previous floor is 1,000 euros. The carrying amount of the previous roof is unknown (as it was acquired with the building) but based on the carrying amount of the building and the estimated portion of the roof therein, the estimated carrying amount of the old roof is 2,000 euros. Simultaneously with the recognition of the new roof and floor, the old roof and floor are expensed.
The painting of walls is an expenditure relating to ongoing maintenance and repairs that is recognised as a period expense based on the materiality principle.

The following entries are made in the books:			
D	Buildings – new roof (depreciated over 30 years)	70,000	
D	Buildings – new floor (depreciated over 10 years)	20,000	

D	Cost of repairs	2,000	
C	Cash	92,000	
D	Write-down of property, plant and equipment	3,000	
C	Buildings – old roof	2,000	
C	Buildings – old floor	1,000	

ACCOUNTING POLICIES FOR INTANGIBLE ASSETS

Initial Recognition

33. ***An intangible fixed asset (except development costs that are discussed in clause 40) shall be recognised in the balance sheet only if:***

(a) the item is under the control of the entity;
(b) it is likely that economic benefits will flow to the entity in the future from using the item;
(c) the cost of item can be reliably determined.

34. If an item of intangible asset has been purchased separately from outside parties or acquired in a business combination, there is a presumption that at the time of their acquisition it is probable that the expected future economic benefits embodied in the asset will flow to the entity. (IFRS for SMEs 18.7) Economic benefits may also translate into cost savings.

35. ***Intangible assets shall initially be measured at cost which comprises their purchase price and other costs directly attributable to the acquisition (incl. costs that are necessary for bringing the asset to its operating condition and location). (IFRS for SMEs 18.9, 18.10).***

36. In determining the cost of intangible assets, principles similar to those applied to determining the cost of property, plant and equipment shall be used (see clauses 11-20).

37. The following expenditures shall not be recognised as intangible assets but are expensed during the period in which they arise (IFRS for SMEs 18.15):

(a) establishment costs (e.g. state fee, legal advice fee);
(b) expenditures related to research (see clause 38);
(c) training costs;
(d) advertising costs;
(e) general administrative expenditures;
(f) losses in the initial stage of production;
(g) relocation and restructuring costs;
(h) costs related to internally generated brands, customer lists and other similar items (however, brands and customer lists acquired from outside parties or in a business combination may be capitalised).

38. Research is an original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. (IFRS for SMEs Glossary of Terms) Expenditures related to research (hereinafter research costs) are related to creating a scientific or technical basis for the introduction of new potential products and services and they shall be expensed as incurred. (IFRS for SMEs 18.14)

39. Development activity is the application of research findings to the development, design or testing of new products, services, processes or systems (e.g. the development of a new recipe or production process). ((IFRS for SMEs Glossary of Terms)) Development activity related expenditures (hereinafter *development expenditures*) are not such expenditures, as a result of which a new independent asset is created (e.g. new software). Expenditures on the creation of a new independent asset are capitalised in the cost of the relevant asset (e.g. the expenditures for the development of new software shall be recognised as a part of the cost of this software).

40. For accounting for development expenditures, an entity must choose one of the following accounting policies:

(a) recognise as an expense at the time when it is incurred (unless it forms part of the cost of another asset that meets the criteria for recognising as an asset (IFRS for SMEs 18.14); or

(b) capitalise as intangible assets if all of the below criteria are met:

(i) there exist technical and financial resources and a positive intention to implement the project;

(ii) the entity is able to use or sell the asset to be created;

(iii) the generation of expected future economic benefits arising from the intangible asset can be estimated (incl. the existence of a market for products and services arising from the project implementation);

(iv) the amount of development costs can be measured reliably.

The selected accounting policy is applied consistently to all development expenditures.

41. Whereas in the research phase possible alternatives are searched for, explored and selected, in the development phase, new products and services already specifically selected are developed, for which a budget has been prepared and a conceptual decision has been made to complete the development work. If the research phase is indistinguishable from the development phase, then all expenditures relating to the given project shall be considered as research costs and expensed as incurred. However, if it becomes evident at a later date that some of the costs had satisfied the criteria for capitalisation, they shall not be capitalised retrospectively.

Example 6 – Research and development expenditures

An entity engages in different activities to develop the business during the year. Which of the below expenditures may be capitalised as intangible assets and which should be expensed:

1. Market analysis, study of new potential sales channels and products, development of project business plan and budget;
2. Development of new sales software enabling the automatic review of new purchase applications, development of a general technical solution;
3. Additional changes to the sales software in order to bring it into compliance with specific needs of various departments;

4. Expenses incurred on the input of data on products currently for sale and current prices into the software;
5. Expenses related to operating of the sales software (incl. ongoing updating of materials);
6. Employee training expenses for teaching how to use the new web pages;
7. Borrowing costs incurred during software development;
8. Development of a recipe for a new product (the product is intended to be sold during the next three years);

Response: Expenditure no 1 is a research-related expenditure that should be expensed as incurred. Expenditures 2–3 are made to create a new independent asset (software), thus are capitalised as assets (see clause 39). Expenditures 4-7 do not meet the criteria for recognising intangible assets and are expensed as incurred (see clause 37). Expenditure 8 is a development cost that shall be accounted for depending on the accounting method selected by the entity (see clause 40) - it may either be expensed as incurred or capitalised as an asset if criteria listed in clause 40 are met.

42. Internally generated goodwill (i.e. difference between an entity's market value and the carrying amount of its net assets) shall not be recognised as an asset in the balance sheet of an entity. (IFRS for SMEs 18.15 (f)).

43. Expenditures on intangible assets expensed in prior periods must not later be capitalised in the cost of intangible assets. (IFRS for SMEs 18.17).

Subsequent Measurement

44. ***Intangible assets shall be carried in the balance sheet at their cost, less accumulated amortisation and any accumulated impairment losses. (IFRS for SMEs 18.18, 19.23).***

45. The accounting policies for property, plant and equipment set out in clauses 21-32 shall also apply to intangible assets, taking into account the differences as described in clauses 46-49.

46. Intangible assets shall be considered to have a finite useful life. The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual rights, but may be shorter if the period over which the entity expects to use the asset is shorter. If the contractual rights can be extended, the useful life of the intangible asset may include the extension period if there is evidence to support extension by the entity without significant cost. (IFRS for SMEs 18.19).

47. If an entity is unable to make a reliable estimate of the useful life of an intangible asset, the asset shall be amortised over up to 10 years. (IFRS for SMEs 18.20, 19.23).

48. The straight-line method shall be used for amortising depreciable intangible assets except in cases when another method provides a more objective view of the allocation of expected future economic benefits embodied in the asset over the asset's useful life. (IFRS for SMEs 18.22).

49. The residual value of a depreciable intangible asset is assumed to be zero unless it is highly probable that the asset can be sold at the end of its useful life (for example, an active market exists for the asset or third parties have committed to purchase the asset). (IFRS for SMEs 18.23).

WRITE-DOWNS OF PROPERTY, PLANT AND EQUIPMENT AND INTANGIBLE ASSETS

Impairment of Assets

50. ***An item of property, plant and equipment and intangible assets shall be written down to its recoverable amount if the recoverable amount of the asset is lower than its carrying amount. (IFRS for SMEs 27.5).***

51. In identifying whether an asset may be impaired, an impairment test shall be performed to determine the recoverable amount of an asset. Clauses 53-55 of this guideline explain under which circumstances an entity has to perform an impairment test. Clauses 56-64 describe the methodology of an impairment test for an individual asset, and clauses 65-70 for groups of assets (cash generating unit) and goodwill. Clauses 71-75 describe the reversal of an impairment.

52. ***Asset impairment losses shall be recognised as expenses of the accounting period. (IFRS for SMEs 27.6) An entity shall include in profit or loss compensation from third parties for items of property, plant and equipment that were impaired, lost or given up only when the compensation becomes receivable. (IFRS for SMEs 17.25).***

Identifying the Need for an Impairment Test

53. ***An entity shall perform an impairment test at each reporting date on those assets where there is any indication of potential impairment. (IFRS for SMEs 27.7)***

54. At each reporting date, the management of an entity shall critically assess whether there are any indications that an asset may be impaired. The following factors may be such indications (IFRS for SMEs 27.9, 17.26):

(a) an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use;

(b) the general economic environment and market situation have deteriorated; accordingly, it is likely that the cash flow (revenue generated by the asset will decrease;

(c) market interest rates have increased, which is why the discount rate used in calculating an asset's value in use has increased and the asset's value in use decreased;

(d) the carrying amount of the net assets of the entity is more than the estimated fair value of the entity as a whole;

(e) the physical condition of assets has sharply deteriorated;

(f) revenues generated by an asset or a group of assets are lower than expected;

(g) the entity plans to discontinue some areas of operations or close some departments or sell assets earlier than planned.

55. If any of the indications described in clause 54 exist (or any other indicator of impairment of an asset), an impairment test shall be performed. When an impairment test is not feasible for an individual asset because the cash flows being generated by the asset are indistinguishable from the cash flows of the rest of the entity, an impairment test shall be performed for the cash-generating unit to which the asset belongs. An impairment test on goodwill shall always be performed together with the cash-generating unit that goodwill belongs to. (IFRS for SMEs 27.8, 27.24).

Impairment Test

56. An impairment test is performed to determine the recoverable amount of an asset, which is the higher of the two indicators – fair value of an asset (less costs to sell) and its value in use. A need for the asset's write-down exists only if both the asset's fair value (less costs to sell) as well as its value in use are smaller than its carrying amount. If the amount calculated first (either the asset's fair value less costs to sell or its value in use) exceeds the asset's carrying amount, it is not necessary to calculate the other amount as the asset's recoverable amount is in any case higher than its carrying amount. (IFRS for SMEs 27.11, 27.12).

57. ***When determining the fair value of asset (les costs to sell) the following fair value indication shall be followed (IFRS for SMEs 27.14):***

(a) ***the price agreed in a binding sale agreement;***

(b) ***if binding sale agreement is not available, the asset's market value on active market;***

(c) ***if there is no binding sale agreement and no active market, an estimated sale price of the asset in an arm's length transaction between independent parties, considering recent similar transactions in the same industry.***

58. If none of the above-mentioned indications of fair value can be estimated reliably, then the recoverable amount of an asset is its value in use.

59. ***For estimating an asset's value in use, a realistic estimate shall be prepared for the cash flows to be derived from the use of the asset in subsequent periods and the present value of these cash flows shall be calculated. (IFRS for SMEs 27.15).***

60. The budgets or forecasts approved by the management for subsequent periods (generally no longer than five years) shall be used as the basis for the cash flow estimate. The cash flows of the periods beyond those covered by the budgets and forecasts approved by the management shall be estimated by applying realistic growth rates to current budgets or projections. The applicable growth rate should generally be either steady or declining and it should not exceed the long-term average growth rate in the market of similar products in the same industry (if appropriate, the applicable growth rate may also be zero or negative). Cash flow estimates shall be prepared so that they do not contain unreasonable contradictions between the historical results of the entity and the respective industry. (IFRS for SMEs 27.16, 27.17).

61. The cash flows used for calculating an asset's value in use shall include all cash flows from the continuing use of an asset and from its disposal at the end of its use, including cash flows necessary for the maintenance and repair of an asset. (IFRS for SMEs 27.17).

62. The cash flows used for calculating an asset's value in use shall neither include the estimated cash flows from additional investments for the improvement of an asset (nor additional income arising from such investments), financing activities (e.g., loan repayments), restructuring to be carried out in future for which the entity has no binding commitment yet, nor any income tax receipts or payments. (IFRS for SMEs 27.18, 27.19).

63. In calculating the present value of cash flows, such an interest rate shall be used as a discount rate that investors would require as a rate of return for a similar project. (IFRS for SMEs 27.20).

64. The applicable discount rate shall take into consideration all risks related to the asset, incl. country risk, foreign currency risk, price risk and other specific risks related to the asset but shall not reflect risks for which the future cash flow estimates have been adjusted. (IFRS for SMEs 27.20) The weighted average cost of capital of an entity may be a good indicator of an appropriate discount rate. However, when determining the appropriate discount rate, it must be kept in mind that it should reflect the market's estimate of asset-specific risks and be independent of how the purchase of this asset was actually financed.

Impairment Test for a Cash-generating Unit and Goodwill

65. When possible, an impairment test shall be performed for each specific asset if there are any indications that it may be impaired. If an impairment test is not feasible for an individual asset because its recoverable amount cannot be determined reliably, an impairment test shall be performed for the smallest group of assets to which the asset belongs and whose recoverable amount can be determined. Such a group of assets is called a cash-generating unit. (IFRS for SMEs 27.8).

66. For example, if it is impossible to determine a single machine's value in use, it should be determined for a group of machines to which this machine belongs; if this is not possible either, it should be done or the whole production unit or when necessary, for the whole entity. Cash-generating unit shall be identified on each accounting period, based on the same principles.

67. Goodwill acquired in a business combination (see ASBG 11 "*Business combination*") involves assets acquired in a business combination that are not separately identifiable. For the purpose of performing impairment tests, goodwill acquired in a business combination shall, from the acquisition date, be allocated to one or more of the cash-generating units (or groups of cash-generating units), that are expected to benefit from this goodwill in the future. (IFRS for SMEs 27.25) If goodwill cannot be allocated to individual cash-generating units on a non-arbitrary basis, the entity shall allocate goodwill as follows:

(a) if an acquired business is not similar to the entity's other business activities and the existing and new business units have not been integrated (i.e. joined), goodwill shall be allocated to the acquired business.

(b) if the acquired business is similar to the existing business activities of the entity and the existing and new business have been integrated, goodwill shall be allocated to this entire business activity.

<u>Example 7 – Allocation of goodwill to test the recoverable amount</u>

An entity AB has two business units: unit A engaged in retailing and unit B engaged in plastic component manufacturing. Both units meet the definition of a cash-generating unit because the cash flows they generate can be separated and are also monitored and managed separately by management.

The group acquired two additional subsidiaries; goodwill arose in both acquisitions. Acquired entity X is engaged in retailing. As the locations of stores owned by X are very suitable for entity AB, complementing the entity's unit A's store network, entity AB hopes to generate significant synergies from the acquisition entity X through revenue growth, as well as cost savings on retail network management. In order to achieve that, it is planning to integrate the operations and management of unit A and acquired unit X, however, initially the entity does not intend to legally join itself with subsidiary X.
Acquired entity Y is engaged in furniture manufacturing. Although the help of unit B's production and other specialists will be needed for the strategic management of entity Y's operations, the plan is to monitor the operations and results of these business units separately.

In order to test the recoverable amount of goodwill, it shall be allocated as follows:
Goodwill that arose upon acquisition of entity X shall be allocated to the entire retailing unit based on sub-clause 67 (b), i.e. the book value of entity X's assets (incl. goodwill arising upon acquisition) and unit A's assets on the consolidated balance sheet are compared with the recoverable amount of entity X + unit A. For example, in determining value in use it means that cash flows generated by both units are taken into account.

Goodwill that arose upon acquisition of entity Y shall be allocated only to entity Y based on sub-clause 67 (a), i.e. the book value of entity Y's assets (incl. goodwill arising upon acquisition) on the consolidated balance sheet is compared with the recoverable amount of entity Y.

68. If an entity reorganises its internal structure in a way that changes the composition of cash-generating units (e.g. they will be combined or divided into parts), goodwill shall be reallocated to the units affected. This reallocation shall be performed in proportion to the relative values of the cash generating units. If an entity disposes of a cash-generating unit (or its part), then goodwill allocated to it shall be written off the balance sheet.

69. An impairment test for a cash-generating unit shall be performed similarly to the impairment test for an individual asset. If the recoverable amount of a cash-generating unit is lower than the sum of the carrying amounts of the assets, then the assets belonging to this unit shall be written down. First, any goodwill (if it exists) allocated to the cash-generating unit shall be written down, then all the other assets of the unit shall be written down pro rata. (IFRS for SMEs 27.21).

70. In the pro rata allocation of an impairment loss, no asset shall be written down to an amount less than the highest of the three indicators below:

(a) asset's fair value less costs to sell (if determinable);
(b) asset's value in use (if determinable); and
(c) zero.

If any asset is written down less due to the reasons above than necessary for a pro rata allocation of impairment loss, the excess amount of impairment loss must be allocated to the remaining assets of the unit on a pro rata basis. (IFRS for SMEs 27.22, 27.23).

Example 8 – Allocation of impairment in a cash-generating unit

A production unit is carried in the balance sheet of an entity whose carrying amount of its assets is 600,000 euros and the carrying amount of goodwill that arose from the one-time acquisition of this unit is 300,000 euros. As the production unit is expected to be closed in three years, it suggests that the recoverable amount of the assets of this production unit may have fallen below their carrying amount.

According to the management's estimate, the expected income and expenses over the following three years are as follows (in thousands of euros):

	Year 1	Year 2	Year 3
Sale of products	800	600	400
Cost of products (incl. material, salary, etc.)	500	350	200
	300	250	200
Repair and maintenance of machinery	50	50	50
Depreciation	200	200	200
Profit before interest	50	0	-50
Interest on the loan for the purchase of machinery	-100	-50	0
Net profit (loss)	-50	-50	-50

The average expected market return on production projects of similar risk is 10%. At the end of year 3, 50,000 euros are expected to be received for the sale of the production equipment (as scrap iron). There is currently no market for the sale of the equipment in working order.

Should this equipment be written down and to what extent?

Response: As the cash flows generated by this production unit are distinguishable from the other cash flows of the entity, this unit may be considered as a separate cash-generating unit. For performing an impairment test, the entity prepares a three-year cash flow estimate for the unit based on the management's forecast. The estimate contains only monetary income and expenses (hence does not include, for example, depreciation) and does not include cash flows from financing activities:

	Year 1	Year 2	Year 3
Sale of products	800	600	400

Cost of products (incl. material, salary, etc.)	-500	-350	-200
	300	250	200
Repair and maintenance of machinery	-50	-50	-50
Cash from the sale of machinery	0	0	50
Net cash inflow	**250**	**200**	**200**
By discounting this cash inflow by 10%, the present value of the cash inflow (or the value of the cash-flow generating unit in use) is 543,000 euros. The fair value of the unit (less costs to sell) is 50,000 euros (sale as scrap iron). As the recoverable amount of the unit is higher than its value in use and the fair value (less costs to sell), then the recoverable amount of this unit is 543,000 euros.			
Considering that the carrying amount of the cash-generating unit is 900,000 thousand euros (600,000 for equipment plus 300,000 for goodwill), then the assets of this unit shall be written down by 357,000 euros (900,000-543,000). First, the entire goodwill allocated to the unit (in the amount of 300,000 euros) shall be written down, and after that the production equipment as well as other non-current assets allocated to the unit shall be written down on a pro rata basis (in the total amount of 57,000 euros).			

Reversal of Impairment Loss

71. At each reporting date, an entity shall assess whether the recoverable amount of assets (except goodwill) written down has increased since then. If this is probable, a new impairment test shall be performed. If there is an indication that the recoverable amount of an asset or asset group (cash generating unit) has increased above the carrying amount, the previous impairment loss shall be reversed and the carrying amount of the asset shall be increased. The upper limit is the carrying amount of the asset that would have been determined, taking into account regular depreciation during the years since recognition of impairment loss. (IFRS for SMEs 27.29-31).

72. In the case of a reversal of an impairment loss for a cash-generating unit, the carrying amount of all assets belonging to it (except for goodwill) shall be increased on a pro rata basis, ensuring that the reversal does not increase the carrying amount of any asset above the limit provided in clause 71 or the recoverable amount of the asset. If the impairment loss of any asset is reversed less due to the reasons above than necessary for a pro rata allocation of impairment loss, the excess amount of impairment loss reversal must be allocated to the remaining assets of the unit on a pro rata basis. (IFRS for SMEs 27.31 (c))

73. An impairment loss recognised for goodwill shall not be reversed. (IFRS for SMEs 27.28).

74. Upon reversal of impairment, the entity shall revise the depreciation rates of assets. (IFRS for SMEs 27.30 (d), 27.31 (e))

75. ***A reversal of an impairment loss for an asset shall be recognised in the income statement for the accounting period as a reduction of impairment loss of non-current assets. (IFRS for SMEs 27.30 (b), 27.31 (b))***

DERECOGNITION OF PROPERTY, PLANT AND EQUIPMENT AND INTANGIBLE ASSETS

76. ***Property, plant and equipment and intangible assets shall be derecognised (IFRS for SMEs 17.27, 18.26):***

(a) ***at the time of their disposal or***

(b) ***when no future economic benefits are expected from their use or disposal.***

77. In determining the date of sale of a non-current asset, conditions provided in ASBG 10 "*Revenue Recognition*" regarding recognition of revenue on the sale of goods shall be used as a basis. (IFRS for SMEs 17.29).

78. The profit or loss arising from disposal or write-off is the difference between the net consideration received or receivable and the carrying amount of the non-current asset. (IFRS for SMEs 17.30).

COMPARISON WITH IFRS FOR SMES

79. The accounting policies prescribed in ASBG 5 for property, plant and equipment are generally in compliance with the accounting policies prescribed in section 17 of IFRS for SMEs except for the principles of measuring borrowing costs, where the Board deemed it necessary to enable a choice of two accounting methods: (a) their capitalisation as cost (in conformity with section 25.2 of IFRS for SMEs) or (b) capitalisation in the acquisition costs of property, plant and equipment (in conformity with IFRS, which requests capitalisation of borrowing costs). The option to make a selection was considered justified, as it enables the entities to comply with the principles of IFRS (e.g. if the entity forms a part of a bigger group preparing its statements based on IFRS). Also, capitalising borrowing costs may become material, if large part of the entity's inventories is composed by an object to be built over a long time and financed with external capital.

80. The accounting policies prescribed in ASBG 5 for intangible assets are generally in compliance with the accounting policies prescribed in section 18 of IFRS for SMEs except for the principles of measuring development costs, where the Board deemed it necessary to enable a choice of two accounting methods: (a) capitalisation of development expenditures as cost (in conformity with section 18 of IFRS for SMEs) or (b) capitalisation as intangible assets. IFRS permits the capitalisation of development costs. The choice was deemed justified because it allows innovative entities engage in development activities without raising additional equity if there is no actual business need for it until the entity starts generating a profit from its developed product or service.

81. The accounting policies described in ASBG 5 for calculating asset impairment losses are to material extent in compliance with the policies prescribed in section 27 of IFRS for SMEs.

82. The rules prescribed in ASBG 5 for expensing borrowing costs are to material extent in compliance with the policies prescribed in section 25 of IFRS for SMEs.