Rough water ahead

Environment, Water

Required: 1. How should Smooth Sailings' management perform the recoverability test for the cruise ship as of December 31, 2010? The following are the required steps to identify, recognize and measure the impairment of a long-lived asset (group) to be held and used: * Indicators of impairment — consider whether indicators of impairment are present. Test for recoverability — If indicators are present, perform a recoverability test by comparing the sum of the estimated undiscounted future cash flows attributable to the asset (group) in question to their carrying amounts (as a reminder, entities cannot record an impairment for a held and used asset unless the asset first fails this recoverability test). Measurement of an impairment — If the undiscounted cash flows used in the test for recoverability are less than the long-lived asset's (group's) carrying amount, determine the fair value of the long-lived asset (group) and recognize an impairment loss if the carrying amount of the long-lived asset (group) exceeds its fair value. What assets and liabilities should be included in the " asset group" as defined by ASC 360-10 for purposes of performing the recoverability test?

For purposes of recognition and measurement of an impairment loss, a long-lived asset or assets shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. Asset groups may include assets and liabilities outside the scope of ASC 360-10 (for example, goodwill — if certain conditions, discussed later, are met — and other non-amortizing intangible assets).

In general, assets should be grouped when they are used together, that is, when they are part of the same group of assets and are used together to generate joint cash flows. If assets and/or liabilities are grouped for purposes of a test for recoverability, they are referred to as an ? asset group. How should the multiple operating scenarios impact the recoverability test? ASC 360-10 allows entities to use either a single-most-likely estimate of expected future cash flows (often referred to as a traditional or best-estimate approach) or a range of possible future outcomes (often referred to as a probability-weighted approach).

However, if alternative courses of action to recover the long-lived asset (group) are under consideration or if a range is estimated for the amount of possible cash flows, the likelihood of possible outcomes should be considered. An entity is not required to use the probability-weighted approach, but it may be useful in considering the likelihood of possible outcomes. If the probability-weighted approach is used, the likelihood of possible outcomes should be considered in determining the best estimate of future cash flows. What impact should the potential foreclosure and extinguishment of debt have on the cash flows used to perform the recoverability test? Generally, debt should not be included in an asset group because the lowest level of identifiable cash flows will typically not include cash flows associated with debt (i. e. , the principal payments associated with the debt). Further, the cash flows associated with debt principal payments are typically easy to identify; therefore, most entities will be able to eliminate the cash flows associated with debt from the cash flows of other assets and liabilities.

However, in rare instances, if the lowest level of identifiable cash flows includes cash flows associated with debt principal payments and it is not practical to eliminate those cash flows (which would be more likely to occur when the asset group is a business or reporting unit), then the debt should be included in the asset group (i. e. , netted with the carrying amounts of the assets of the group) so as to maintain an appropriate comparison. This basis adjustment provides the same result as if the debt principal payments have been excluded (e. g. debt with a carrying value of $100 would have undiscounted cash flows of $100). As a reminder, the guidance in ASC 360-10 prohibits the inclusion of interest expense in assessing the recoverability of long-lived assets. When the FASB originally deliberated Statement 144, it considered and rejected requests for a limited exception to the fair value measurement for impaired long-lived assets that are subject to nonrecourse debt. Some constituents believed that the impairment loss on an asset subject entirely to nonrecourse debt should be limited to the loss that would occur if the asset were put back to the lender.

The FASB decided not to provide an exception for assets subject to nonrecourse debt. In its basis for conclusions, the FASB explained that the “ Recognition of an impairment loss and the recognition of a gain on the extinguishment of debt are separate events, and each event should be recognized in the period in which it occurs. The Board believes that the recognition of an impairment loss should be based on the measurement of the asset at its fair value and that the existence of nonrecourse debt should not influence that measurement. ” (Statement 144, paragraph B34) 2.

What impairment loss, if any, should be recorded as of December 31, 2010? As discussed above, if indicators of impairment exist for an asset (group) to be held and used, an entity determines whether the sum of the estimated undiscounted future cash flows attributable to the asset (group) in question is less than its carrying amount. If those undiscounted cash flows are less than the carrying amount, then an entity will recognize an impairment loss based on the excess of the carrying amount of the asset (group) over its respective fair value.

However, under ASC 820 cash flows used to determine fair value (using a present value technique) when determining the impairment loss (Step 3) must include assumptions that market participants would use in their estimates of fair value. As a result, entities are not able to simply apply a discount rate to the cash flows used in Step 2 to determine fair value without first determining whether they reflect the expectations of market participants.

Entities may use their own assumptions as a starting point in developing market participant assumptions and apply reasonable judgment in analyzing whether such assumptions are representative of market participant assumptions. The determination of market participant assumptions and their effect on fair value estimates are particularly subjective considering that the evaluation is being made for assets to be held and used. When multiple valuation techniques are used, the merits of each valuation technique and the underlying assumptions embedded in each of the techniques should be considered in evaluating and assessing the results.

In this case, we do not know the assumptions for the estimated fair value of $3. 0 million and we consider the discounted cash flow is more reliable. The first step is to check impairment indicator. Because of an increased presence of pirate in the area which Smooth Sailing cruises, the cruise ship's operating performance has significantly declined which has directly contributed to a decline in its overall fair value, and may indicate a potential impairment. In the second step, we did the recoverability test.

The undiscounted cash flow is the sum of expected operating cash flow and the cash flow from the net working capital. Calculation is shown below: We use the probability-weighted approach to get the estimated future cash flow ($2. 30) which is smaller than the net book value. As a result, the cruise is not recoverable. In the third step, we calculated the impairment loss. We calculated the discounted cash flow as follow: So an impairment of 2. 44 million should be recorded, which is the difference between the net book value of 4. million and the discounted cash flow of 2. 16 million. The detailed calculation is included in the attachment " rough water ahead. xlsx" Alternate Facts: Would the outcome of the recoverability and impairment tests change if the probability assessment was revised such that there was a 50 percent, 40 percent, and 10 percent probability of scenarios A, B, and C occurring, respectively? If so, how? An impairment of 0. 62 million should be recorded. The calculation is included in the attachment " rough water ahead. xlsx"