Case 12-9

Rough Waters Ahead

Smooth Sailing is a private company that operates one cruise ship. Smooth Sailing's purchase of the cruise ship was financed with nonrecourse debt. (Nonrecourse debt is a loan that is secured by a pledge of collateral, in this case the cruise ship, but for which the borrower is not personally liable. If the borrower defaults, the lender can seize the collateral, but the lender's recovery is limited to the collateral.) The cruise ship has its own identifiable cash flows that are largely independent of the cash flows of other asset groups.

Because of an increased presence of pirates in the area in which Smooth Sailing cruises, the cruise ship's operating performance has significantly declined, which has directly contributed to a decline in the ship's overall fair value. In the current year (2010), Smooth Sailing's annual operating cash flows have declined by 30 percent to $1.0 million, and its annual operating cash flows are expected to continue to decline in the near term. Because of this decline in the cruise ship's fair value and operating performance, Smooth Sailings' management is evaluating the following possible options for proceeding into 2011 and beyond:

			Estimated Future Cash Inflows — Undiscounted					
Option		**Probability of Occurring**	**2011**	**2012**	**2013**	**2014**	**2015**	**Total**
A	Continue operating the cruise ship in the current area.	10%	$1.0M	$0.9M	$0.7M	$0.7M	$0.7M	**$4.0M**
B	Operate the cruise ship in a new area where there are no pirates.	20%	$0.6M	$0.8M	$1.1M	$1.6M	$1.9M	**$6.0M**
C	For 2011, operate the cruise ship in the current area despite the increased presence of pirates. On December 31, 2011, turn the cruise ship back to the lender (e.g., foreclosure).	70%	$1.0M	$0	$0	$0	$0	**$1.0M**

These events indicate that the carrying amount of the asset group may not be recoverable and, therefore, Smooth Sailing will test the asset group for recoverability and potential impairment in accordance with ASC 360-10 as of the end of the current fiscal year, December 31, 2010.

As of December 31, 2010, the cruise ship's estimated fair value is $3.0 million, net book value is $4.6 million, and estimated remaining useful life is five years. In addition, the net carrying value of the nonrecourse debt is $4.0 million; there is $0.1 million of net working capital (carried at fair value) directly attributable to the cruise ship; and Smooth Sailing has determined that an annual discount rate of 7 percent is appropriate.

Required:

1. How should Smooth Sailings' management perform the recoverability test for the cruise ship as of December 31, 2010? In addressing this question, consider:
   - What assets and liabilities should be included in the "asset group" as defined by ASC 360-10 for purposes of performing the recoverability test?
   - How should the multiple operating scenarios impact the recoverability test?
   - What impact should the potential foreclosure and extinguishment of debt have on the cash flows used to perform the recoverability test?
2. What impairment loss, if any, should be recorded as of December 31, 2010?

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?