

Financial Accounting Standards Board

401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 | 203-847-0700
Ext. 250

Fax: 203-849-9714



TIMOTHY S. LUCAS
Director
Research and Technical Activities

August 13, 1997

Sir Bryan Carsberg
Secretary-General
International Accounting Standards Committee
167 Fleet Street
London, EC4A 2ES
United Kingdom

Dear Sir Bryan:

This letter responds to the International Accounting Standards Committee's (IASC) Exposure Draft of a proposed International Accounting Standard, *Impairment of Assets*, (E55). We commend the IASC for its continuing efforts to improve international accounting standards and appreciate the opportunity to comment on this proposal.

The views expressed in this letter are those of the Financial Accounting Standards Board's (FASB) technical staff responsible for its preparation and have been developed based on their expertise in accounting for the impairment of long-lived assets. Those views may or may not be shared by individual Board members or other FASB staff. It does not represent an official position of the FASB. Official positions of the FASB are determined only after extensive due process and deliberation to which this letter has not been subjected.

In keeping with the FASB's mission statement, our main objective in responding to the IASC's Exposure Draft is to contribute to the development of superior international accounting standards that will increase comparability of financial reporting worldwide. Accordingly, where applicable, this letter:

- a. Identifies significant similarities and differences between the Exposure Draft and present U.S. generally accepted accounting principles (GAAP)
- b. Identifies inconsistencies within the proposed accounting and, to the extent that they are readily apparent, inconsistencies with other IASC standards
- c. Identifies potential problem areas where the proposed guidance is unclear or additional guidance is needed
- d. Responds to the questions posed in the Exposure Draft's Invitation to Comment.

Although this comment letter identifies significant similarities and differences between the IASC proposals and U.S. GAAP, this letter serves different objectives than those of our Special Report, *The IASC-U.S. Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S. GAAP*. When the final IASC standard on impairment is issued, a comprehensive and detailed comparison of the type found in the Special Report may reveal additional similarities and differences that have not been identified in this letter.

Whether an IASC proposal is similar to or different from U.S. GAAP is not necessarily a reflection of the level of quality of the IASC proposal. We believe that other characteristics also are important to that assessment; for example, adherence to a conceptual basis, accounting requirements for similar types of events and circumstances, and clear and sufficient guidance that will ensure consistent application. On that basis, where possible, we have made suggestions that we believe, if incorporated, would result in a superior international standard.

The Exposure Draft provides a thorough discussion of its approach and of the alternative approaches considered. To avoid repeating that discussion, we have limited our detailed comments to those aspects of the Exposure Draft that we believe to be significant. Accordingly, some of the potential areas for comment have been omitted in this letter. The fact that we did not specifically comment on some aspects of the Exposure Draft should not be taken as either agreement or disagreement with them.

General Comments

In the United States, generally accepted accounting principles addressing the impairment of long-lived assets are established by FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Asset to Be Disposed Of*. Since the issuance of Statement 121 in March 1995, implementation issues have arisen relating primarily to its provisions for assets to be disposed of. In August 1996, the FASB added a project to its agenda to address those issues. Deliberations on that project continue.

In general, both the scope and the objectives of the Exposure Draft are consistent with Statement 121. The guidance provided in the Exposure Draft, while similar, is more detailed than the guidance provided in Statement 121. We believe that the detailed guidance provided in the Exposure Draft will facilitate its implementation. We commend the IASC's efforts to provide that level of guidance in this Exposure Draft.

We observe that there are two fundamental differences between the Exposure Draft and Statement 121. The Exposure Draft proposes to use an impairment recognition trigger based on a discounted measure and, in certain circumstances, to require the reversal of impairment losses in subsequent reporting periods. In contrast, Statement 121 uses an impairment recognition trigger based on an undiscounted cash flow measure and does not permit the reversal of impairment losses (for assets held and used). Another difference is that the Exposure Draft proposes to measure an impaired asset at the higher of net selling price and value in use, whereas Statement 121 measures an impaired asset at its fair value (or fair value less cost to sell).

Conceptually we understand the basis for an approach that uses a discounted measure to recognize impairment losses. However, because that approach, in combination with the reversal of impairment losses, would require an entity to make an almost continuous assessment of assets for impairment, we question whether the implementation of that approach would be operational. Those and other issues raised by the Exposure Draft are discussed in more detail below.

SIGNIFICANT ISSUES

Recognition of an Impairment Loss

In response to Question 4, we believe that an impairment loss should be recognized whenever the carrying amount of an asset or group of assets exceeds its impairment recognition trigger. The greatest difference between the Exposure Draft and Statement 121 is the measurement used for that recognition trigger. The Exposure Draft proposes to use a discounted measure—the higher of an asset's net selling price and value in use (recoverable amount). In contrast, Statement 121 uses an undiscounted measure—the sum of the entity's estimate of the undiscounted cash flows expected to result from the asset's continuing use and eventual disposition.

Those different recognition triggers raise the fundamental issue of whether an impairment loss should be triggered based on a discounted or undiscounted measurement. A discounted recognition trigger would presumably recognize impairment losses more frequently than Statement 121. Because the Exposure Draft, in certain circumstances, also requires an entity to reverse those losses in subsequent reporting periods, we believe the Exposure Draft would require an entity to make an almost continuous assessment of assets for impairment in all reporting periods. Our primary concern is that that approach would not be operational if applied in practice.

The practical application of an approach to recognizing impairment losses was considered by the FASB in deliberating Statement 121. As discussed in paragraph 67 of Statement 121:

The recognition approach adopted by the Board must be operational in an area of significant uncertainty. The Board's approach requires the investigation of potential impairments on an exception basis. An asset must be tested for recoverability only if there is reason to believe that the asset is impaired as evidenced by events or changes in circumstances. If that test indicates that the sum of the expected future cash flows (undiscounted and without interest charges) to be generated by the asset is insufficient to recover the carrying amount of the asset, the asset is considered impaired. That approach uses information that the Board believes is generally available to the entity.

As discussed in paragraph 57 of Statement 121, "management has the responsibility to consider whether an asset is impaired but that to test each asset each period would be too costly." We believe that, from a practical standpoint, an undiscounted cash flows recognition trigger should be used. We believe that the potential usefulness of that approach is sufficient to overcome objections to its use.

Indicators of Potential Impairment

In response to Question 8(a), we believe that an entity should review an asset for impairment if events or circumstances indicate that the carrying amount of the asset may not be recoverable. We agree that those events or circumstances, or impairment indicators, should be used as a screening mechanism to require that review only when there is an indication that the asset may be impaired. Statement 121 provides similar guidance.

In response to Question 8(b), we observe that the Exposure Draft provides examples of impairment indicators that are similar to, but more detailed than, the impairment indicators identified in Statement 121. We believe that those impairment indicators will be critical in implementing the Exposure Draft and we support the detailed guidance provided.

However, we are concerned that some of the impairment indicators identified in paragraph 8 of the Exposure Draft will require that an asset be reviewed for impairment when there is not a significant risk that the asset may be impaired. Those impairment indicators would require an entity to review an asset for impairment in response to events and circumstances that are "expected" or that "will" occur in the "near future" and, more specifically, in response to the circumstances referred to in paragraph 8(f). The impairment indicator in paragraph 8(f) would require an entity to review an asset for

impairment when "evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected." As discussed in paragraph 11 of the Exposure Draft, management's review of the asset for impairment would be made before operating losses, if any, are recognized. We do not necessarily view those circumstances to be an indicator of impairment.

We suggest that if the impairment indicators identified in a final standard refer to events or circumstances that are "expected" to occur or that "will" occur in the near future, that those terms be defined to refer to a specified level of probability (for example, to events that are *probable* or that *more likely than not* will occur) and that the term *near future* be defined to refer to a specified period of time (for example, one year). We also suggest that the impairment indicator in paragraph 8(f) be eliminated. We observe that those terms are used throughout the Exposure Draft. For example, the term *near future* is used in its discussion of assets held for disposal. If those terms are used in a final standard, we suggest that they be used consistently.

Reversal of Impairment Losses

In response to Questions 5 and 6, we do not agree that an entity should reverse impairment losses for tangible assets, goodwill, or other intangible assets as proposed in paragraphs 70-78 of the Exposure Draft. While Statement 121 requires an entity to report subsequent revisions in estimates of fair value less cost to sell for assets held for disposal, it prohibits the reversal of impairment losses for assets held and used.

As stated previously, we believe that because the Exposure Draft, in certain circumstances, requires an entity to reverse impairment losses, an entity would need to make an almost continuous assessment of assets in all reporting periods. As stated in paragraph 67 of the Exposure Draft, "an enterprise should perform a review at *each balance sheet date* to assess whether there is any indication that an impairment loss recognised for an asset in prior years may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset" (emphasis added). Further, additional disclosures proposed in paragraph 83 of the Exposure Draft would require an entity to disclose information relating to an asset or group of assets that is reviewed for impairment even if an impairment loss is not recognized.

We observe that the revaluation of assets is consistent with the IASC Framework and with the economic criterion that forms the basis for the Exposure Draft's approach to recognizing impairment losses. However, we question whether an almost continuous assessment of assets for impairment would be consistently applied and whether it would limit the usefulness of the information provided to financial statement users by allowing excessive management discretion in deciding whether to defer (or accelerate) recognition

of an impairment loss (or the reversal of that loss) to a future (or current) period (that is, to potentially smooth reported earnings) by adjusting estimates of cash flows.

We also question whether the almost continuous assessment of assets for impairment would permit management to accrue future operating losses (as a reduction to the carrying amount of an asset) that would not otherwise meet the criteria for recognition of a loss contingency under the proposals in the IASC's Draft Statement of Principles, *Provisions and Contingencies* (DSOP). As stated in paragraph 25 of that DSOP, "if the trigger for recognition is set too early, the result would be to recognise a liability and an expense where none exists, thus reducing the relevance and reliability of the financial statements." As further discussed in paragraph 58 of the DSOP:

If provisions are recognised for operating losses in advance of the losses being incurred, the operating results for the period in which the provision is recognised are obscured by the charge for future losses, and the result for the period in which the losses are incurred is obscured by the reduction in the amount of the provision.

Similar concerns arise under Statement 121, which will be addressed as part of our Statement 121 impairment project. We suggest that the IASC also consider addressing those concerns in a final standard.

We are also concerned that the almost continuous assessment of assets for impairment would impose an unnecessary burden on preparers of financial statements and would not be cost-effective. However, if those assessments are required in a final standard, we question the usefulness of using impairment indicators as a screening mechanism to identify assets that are potentially impaired. That is, we question whether to be consistently applied that standard should require the continuous assessment of *all* assets for impairment (that is, whether all assets should be marked to market).

Prior to the issuance of Statement 121, the FASB conducted a survey of members of the Financial Executives Institute. As discussed in paragraph 190 of the FASB Discussion Memorandum, *Accounting for the Impairment of Long-Lived Assets and Identifiable Intangibles* (December 1990), 63 percent of the respondents surveyed stated that it was inappropriate to restore all of part of a write-off and that reversals could lead to abuses in practice. That Discussion Memorandum also states:

Subsequent adjustments might cause users to question the credibility of the initial measurements. This criticism is especially true if the impairment was classified as permanent in nature. Others comment that the volatility of such an adjustment creates a poor measure of operating results from year to year. They claim that periodic, short-term income measurements should not be affected by unrealized changes in the measurement attribute of a long-lived asset or intangible. [paragraph 192]

Measurement of an Impairment Loss

In response to Question 1, we support an approach that would remeasure an impaired asset at its fair value, the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction, as required under Statement 121. As discussed in paragraph 72 of Statement 121, "the Board believes that fair value is an easily understood notion The fair value measure is basic to economic theory and is grounded in the reality of the marketplace." We observe that that same rationale underlies the fair value disclosure requirements in paragraphs 77-87 of the IASC Exposure Draft, *Financial Instruments: Disclosure and Presentation* (E32).

Consistent with that view, if a market exists for an asset, the asset's fair value would be based primarily on its market price regardless of its value in use. That is, a quoted market price is the best evidence of fair value. However, if a quoted market price does not exist for the asset, an entity would estimate fair value similar to the way it would estimate value in use. As stated in paragraph 75 of Statement 121:

. . . There may be practical problems in determining the fair value of certain types of assets covered by this Statement that do not have quoted market prices in active markets. While the objective of using a valuation technique is to determine fair value, the Board acknowledges that in some circumstances, the only information available without undue cost and effort will be the entity's expected future cash flows from the asset's use.

We are concerned that the use of an alternative value-in-use measure could permit management to inappropriately substitute its judgment in estimating the future cash flows expected to result from an asset and in selecting the appropriate discount rate, for the market's judgment in establishing fair value. We are also concerned that its use could permit management to defer recognition of an impairment loss to the period in which an asset is sold. As a consequence, impairment losses on long-lived assets could go unrecognized for extended periods of time. We believe that, when a quoted market price is available, fair value is the only reliable and relevant measure of an impaired asset. We strongly recommend that a final standard require the use of a fair value measurement for impaired assets.

OTHER ISSUES

Assets Held for Disposal

In response to Question 3, we believe that an entity should review for impairment assets held for disposal. However, we do not agree that when those assets are identified as impaired they should be measured at the higher of net selling price and value in use. We believe that those assets should be measured at fair value less cost to sell (net selling price), as required under Statement 121.

In response to Question 9, we agree that net selling price should be determined as proposed in paragraph 5 of the Exposure Draft. We also agree with the statement in paragraph 34 of the basis for conclusions of the Exposure Draft that "the Board believes that the definition of net selling price will lead to a reliable measurement of the net amount that an enterprise can expect to recover from the sale of an asset." Furthermore, because the carrying amount of an asset held for disposal will be recovered through sale, and not use, we believe that the only relevant and reliable measure of an asset's impaired value is its net selling price.

Unlike Statement 121, the Exposure Draft does not distinguish between the accounting that should be applied to an asset held and used and an asset held for disposal. Under the Exposure Draft, it is unclear (a) whether any separate accounting should be applied to an asset held for disposal that does not comprise a segment of a business or (b) when estimates of cash flows used to determine an asset's value in use should reflect an asset's disposal. Paragraph 23(a) of the Exposure Draft states that "cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the *probable* set of economic conditions that will exist over the remaining useful life of the asset" (emphasis added). That raises the question of when cash flow estimates used in the review of an asset for impairment should be revised for the asset's disposal.

We suggest that in a final standard the IASC consider (a) providing additional guidance to specify when cash flow estimates should be revised for an asset's disposal such as, for example, when an asset's disposal is *probable* and (b) requiring disclosure of assets held for disposal, regardless of whether those assets have been identified as impaired.

Value in Use

In response to Question 10, except as discussed below, we generally support the requirements and guidance in the Exposure Draft for the (a) basis for estimates of future cash flows as proposed in paragraphs 23-27, (b) composition of the estimates of future cash flows as proposed in paragraphs 28-35, and (c) selection of the discount rate as proposed in paragraphs 36-40. Those requirements and guidance are more specific than

those provided in Statement 121. We believe that the Exposure Draft's guidance will facilitate its implementation and we commend the IASC's efforts to provide that level of guidance in this Exposure Draft.

Paragraph 29 of the Exposure Draft specifies that an entity should use cash flow estimates that:

Reflect only cash inflows relating to the asset that was initially recognised (or the remaining portion of that asset if it has been already consumed or sold). This avoids including in the asset's value in use cash inflows flowing from internally generated goodwill or from other assets.

We note that the Exposure Draft attempts to avoid recognizing as an asset internally generated goodwill by excluding cash flows generated from internally generated goodwill from the value-in-use calculation. We believe that that provision contradicts the fundamental premise supporting the use of a value-in-use measure; specifically, that a value-in-use measure should represent entity-specific cash flow estimates (based on entity-specific assumptions). It is also inconsistent with the statement made in paragraph 16(c) of the basis for conclusions of the Exposure Draft that "the Board believes that in assessing the recoverable amount of an asset, what counts is the amounts that an enterprise can expect to recover from that asset, including the effect of synergy with other assets." It is unclear how cash flow estimates that purport to represent entity-specific cash flows would do so if cash flows generated from internally generated goodwill (that is, the effect of synergy with other assets) are explicitly excluded. In addition, it is unclear how cash flows generated from internally generated goodwill should be identified.

Paragraph 36 of the Exposure Draft specifies that an entity should use a "pre-tax market-determined rate (or rates) that reflects current assessments of the time value of money and the risks specific to the asset." Because the Exposure Draft uses a discounted measure to recognize and measure an impairment loss, the selection of the discount rate will have a significant impact on the frequency and magnitude of reported impairment losses (and the reversal of those losses). As noted in the Exposure Draft, many long-lived assets are not actively traded and will not have quoted market prices. It is unclear how, in those circumstances, a market-determined rate (or rates) would be reliably determined.

For example, page 48 of the Exposure Draft provides an example that uses a net selling price of zero because a ready buyer does not exist for the assets of the unit. Yet, in determining the unit's value in use, it uses a discount rate (of 15 percent) that "represents the pre-tax current market-determined rate that reflects the time value of money and the risks specific to the Country A operations." In that example no reference is made to how that discount for risk was determined.

Cash-Generating Units

In response to Question 11, we agree that an entity should review an asset for impairment as part of its cash-generating unit if the asset does not generate cash inflows that are largely independent from those of other assets or asset groups as proposed in paragraphs 46 and 47 of the Exposure Draft. A similar requirement is provided in Statement 121.

In response to Question 12, we agree with the requirements and guidance for determining the items that should be included in a cash-generating unit as proposed in paragraph 5 of the Exposure Draft. Similar requirements are provided in Statement 121.

In response to Question 13, we generally support the guidance to recognize and measure an impairment loss if the entity has recognized goodwill or other corporate assets that relate to a cash-generating unit as proposed in paragraphs 59-61 of the Exposure Draft. Similar guidance is not provided in Statement 121, and related implementation issues have arisen. Resolving those issues is important, and we commend the IASC's efforts to provide guidance to address those issues in this Exposure Draft.

In response to Question 14, we support the procedures for allocating an impairment loss of a cash-generating unit as proposed in paragraphs 62-65 of the Exposure Draft. Although similar detailed guidance is not provided in Statement 121, we support that level of detail in this Exposure Draft.

Disclosures

In response to Question 15, if a final standard requires reversals of impairment losses, we support the disclosure requirements proposed in paragraphs 79-81 of the Exposure Draft. However, we suggest that a final standard also require disclosure of the accumulated impairment losses net of reversals, if any, as of the balance sheet date. We disagree with the view discussed in paragraph 90 of the basis for conclusions that there is no benefit in disclosing information about impaired assets in subsequent periods and that that requirement would compel an entity to maintain separate records for impaired assets with no real benefits.

We agree with the discussion in paragraph 89 of the basis for conclusions that disclosure of the accumulated impairment losses net of reversals, if any, would enable "users to develop a more accurate profile of a company, its economic characteristics and its unique operating, financial, and investment characteristics [and that that information would be] particularly useful for making comparisons." In addition, we believe that an entity would not be required to maintain records that are not already required by other provisions of the Exposure Draft.

In response to Question 16, if value in use is used to measure an impaired asset, we recommend that the disclosures proposed in paragraph 82(d) of the Exposure Draft also require disclosure of the discount rate(s) and assumed long-term average growth rate used in the calculation, as referred to in paragraph 93(c) of the basis for conclusions. As discussed previously, the selection of the discount rate will have a significant impact on the frequency and magnitude of reported impairment losses (and the reversal of those losses). By merely changing the discount rate, an entity can appear to be more profitable in the future than in the past. Therefore, we believe that the discount rate used in a value-in-use calculation should be disclosed.

We disagree with the view discussed in paragraph 95 of the Exposure Draft that "it is not the role of users of financial statements to verify how a recoverable amount has been estimated as this is the role of the external auditors." However, even if one accepts that view, we question whether that verification would be made consistently under differing international auditing standards. We agree with the discussion in paragraph 94 of the basis for conclusions that "since judgment will be used in determining an impairment loss . . . users should be provided with enough information so that they can make their own judgment in respect of management's judgment."

In response to Question 17, we do not agree that additional disclosures should be required when an impairment loss is not recognized, as proposed in paragraph 83 of the Exposure Draft. We do not believe that the information is relevant or that it would provide financial statements users with any real benefits. We believe that the supplemental disclosures we have suggested above would be more relevant and provide more useful information to financial statement users than those proposed.

In response to Question 18, we support the disclosure requirements proposed in paragraph 85 of the Exposure Draft when the use of actual cash flows in previous periods would have required the recognition or the reversal of an impairment loss in those periods. We believe that those disclosures provide a safeguard against abuses that could potentially arise when estimating cash flows. In those circumstances, we also suggest that a final standard require that financial statements disclose what the impact of recognizing that loss or reversal of a loss would have been on the results of operations subsequently reported.

In response to Question 19, we support the view that an entity should not be required to disclose how cash-generating units are determined as discussed in paragraphs 102-105 of the basis for conclusions.

In response to Question 20, the only additional disclosures that should be required are noted above.

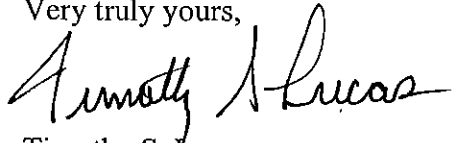
Sir Bryan Carsberg, Secretary-General

August 13, 1997

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We appreciate the opportunity to comment on this Exposure Draft. We would be pleased to answer any questions that you may have or discuss any aspect of the Exposure Draft or this letter at your convenience.

Very truly yours,

A handwritten signature in cursive script, reading "Timothy S. Lucas". The signature is written in dark ink and is positioned above the printed name.

Timothy S. Lucas