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The Secretary-General
International Accounting Standards Committee
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Our ref djl/815

Contact David Littleford
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Dear Sir

Proposed International Accounting Standard E55 - Impairment of Assets

We welcome the opportunity to comment on the IASC Proposed International Accounting Standard E55 *Impairment of assets*. Our major concerns are set out below and we set out our comments on each of the Committee's questions in the appendix.

We should say at the outset that we support the broad thrust of the Proposed Standard. However, we have significant concerns regarding cash-generating units and the need for guidance on the use of risk adjusted rates for discounting. We address each of these issues below.

Cash-generating units

We believe that future cash flows may often be an appropriate basis for measuring value in use but are concerned that, as proposed, the method of identifying relevant cash flows could result in undesirable variations in practice. In computing the cash flows, it is proposed that all expected future cash flows from independent groups of related assets (the cash-generating unit) should be taken into account. The identification of cash-generating units is going to be a difficult judgement area liable to different interpretations, that might give rise to very different apparent impairments.

The paper defines a cash generating unit as the smallest identifiable group of assets that generates cash *inflows* from use that are largely independent of the cash inflows from other assets or groups of assets.

In the UK, the ASB has proposed a similar approach, although from the starting point of dividing total income into the smallest individual *income* streams that are largely independent of



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each other. However, in the USA FAS 121 refers to the lowest level for which there are identifiable cash flows that are largely independent, implying that this includes both inflows and outflows. We feel that agreement should be sought in this area in order to eliminate inconsistencies in the accounts of companies operating in similar sectors and to clarify any divergence from the eventual UK and US approaches.

In addition, we believe identification should have regard to wider economic linkages which are required by management in the way that they run a business, rather than simply on 'cash inflows'. For example, how should companies with retail outlets define cash generating units - as individual outlets (where cash inflows are independent) or using some combination (such as those in a particular geographical area) reflecting management views on critical mass, flagship sites which promote the brand, etc? These could result in very different levels of provision, and may have a significant effect on future reported profitability. The identification of cash-generating units in most complex businesses should be a matter for the judgement of the company's management and review by its auditors, properly having regard to economic linkages as well as cash inflows.

Discount rate

Whilst we agree with the use of a risk adjusted discount rate in the calculation of recoverable amounts, we feel that it is essential that additional practical guidance be provided on the assessment of the appropriate rate.

As we explain in our answers to questions 9 and 10, we consider that a post-tax discount rate should be applied to cash flows that include tax cash flows, rather than a pre-tax rate and tax-exclusive cash flows as proposed.

The US experience

FAS 121 was mandatory in the US for December 1996 financial statements. We understand that a number of practical problems have been encountered in its implementation. These problems relate to:

- identification of income-generating units - diverging practice may be evolving as some corporations are considering evaluating impairment on a geographical basis while others are considering doing so on an individual outlets basis.
- allocation of head office overheads when computing individual outlets' cash flows (eg advertising, area managers' costs, etc) - it appears that the proposed standard addresses this particular issue.



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We trust that our views are of assistance to the Committee in progressing this important issue. If you would like to discuss them further please do not hesitate to contact Lynn Percy on 0171 311-5467 or David Littleford on 0171 311-5926.

Yours faithfully

A handwritten signature in black ink, appearing to be 'L. Percy'.

KPMG

cc: Accounting Standards Board

Enclosure

Q1 Which of the following approaches do you support:

- a The recoverable amount of an asset should be measured as the higher of its net selling price and its value in use (paragraphs 5 and 12-40 of the Exposure Draft and paragraphs 7-30 of the Basis for Conclusions)?*
- b The recoverable amount of an asset should be measured as the fair value of the asset, that is, the amount obtainable for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. Fair value would be primarily based on the asset's market price if a market exists for that asset regardless of the value in use of the asset. If no market exists for the asset, fair value would be estimated in a similar way to value in use as defined in the Exposure Draft (paragraphs 13-19 of the Basis for Conclusions)?*
- c Other (please specify)?*

We strongly support the approach set out in (a) above.

Q2 One consequence of the approach adopted in this Exposure Draft (or the alternative definition of recoverable amount based on fair value) is that present value techniques should be used to measure the recoverable amount of an asset, implicitly (net selling price) or explicitly (value in use) (paragraphs 7-9 and 11-12 of the Basis for Conclusions). Do you agree that present value techniques should be used to measure the recoverable amount of an asset, implicitly (net selling price) or explicitly (value in use)?

There is clearly a logical inconsistency in comparing discounted cash flows and historical cost, when the valuation arrived at will not be rediscounted in future years. However, we agree with the approach proposed by the standard as a practical solution which is consistent with current thinking. However, we would wish to see the standard reviewed relatively early after its implementation, not in terms of its detail but to ensure that its conceptual basis remains appropriate.

Assets Held for Disposal

Q3 Do you agree that the definition of recoverable amount in paragraph 5 of the Exposure Draft is just as applicable to an asset held for disposal as to an asset held for continuing use (paragraph 26 of the Basis for Conclusions)?

We do not believe that it would be appropriate to carry an asset at its value-in-use when it is held for sale, if the two values were to differ materially. However, we agree with the comment in paragraph 13 and think that this will rarely be the case, since the majority of the future cash flows will relate to the imminent cash inflow on sale of the asset. As a result, the recoverable amount will equate to the NSP, as one would wish and expect.

Recognition of Impairment Losses

Q4 Do you agree that an impairment loss should be recognised for an asset:

- a Whenever the recoverable amount of the asset is less than its carrying amount (paragraph 41 of the Exposure Draft and paragraphs 59-67 of the Basis for Conclusions); and*

Yes, when the recoverable amount of the asset is able to be estimated individually.

Do you agree that an impairment loss should be recognised for an asset:

- b Only if the cash-generating unit to which the asset belongs is impaired (paragraphs 55-58 of the Exposure Draft and paragraphs 74-75 of the Basis for Conclusions)?*

We agree that, where the recoverable amount of an asset cannot be assessed without reference to its cash generating unit, an impairment loss should be recognised only when that cash generating unit has been impaired.

Reversals of Impairment Losses

Q5 Do you agree that an impairment loss recognised in prior years for an asset carried on an historical cost basis should be reversed up to the depreciated historical cost of the asset if, and only if, there has been a change in the estimates used to determine the impaired asset's recoverable amount since the last impairment loss was recognised (paragraphs 70-76 of the Exposure Draft and paragraphs 83-87 of the Basis for Conclusions)?

No. We believe that a reversal should be made only where there is a change in *circumstances*, which we would expect to be less frequent. Allowing reversals to be recognised on the basis of changing estimates may lead to volatility and is clearly open to abuse. The subjectivity of the reversal would make it difficult for auditors usefully to assess, and provide assurance on, the figures. We would prefer a focus on "circumstances" and suggest using the phrase and approach adopted in the current version of IAS 16 para 59, part of which is quoted in para 87 of Appendix 3: 'when the circumstances and events which led to the write down or write off cease to exist and there is persuasive evidence that the new circumstances and events will persist for the foreseeable future'.

This approach would mitigate, somewhat, the apparent move by the IASC from assessing and recognising only permanent diminutions to recognising almost all changes in recoverable amount, which we do not support in principle within the context of a still largely historical cost framework of financial reporting.

Q6 Do you agree that an impairment loss recognised for goodwill and other intangible assets for which no active market exists should be reversed in a subsequent period if, and only if, the external event that caused the recognition of the impairment loss has reversed (paragraphs 77-78 of the Exposure Draft)?

Yes, this proposal maintains the requirement for the non-recognition of internally generated goodwill.

Scope

Q7 Do you agree that the Standard should apply to all assets except those listed in paragraph 1 of the Exposure Draft (paragraphs 1-4 of the Exposure Draft and paragraphs 106-110 of the Basis for Conclusions)?

Yes.

Identifying a Potentially Impaired Asset

Q8 Do you agree that:

- a The recoverable amount of an asset should be estimated if, and only if, there is an indication that the asset is impaired; and*
- b The list of indicators of impairment included in paragraph 8 of the Exposure Draft will require an enterprise to estimate the recoverable amount whenever there is a significant risk that the asset is impaired? (paragraphs 6-12 of the Exposure Draft)*

We agree with (a) as it would be onerous to require a review for recoverable amount to be carried out where there was no indication that an impairment has occurred.

However, in terms of the assertion in (b) above, we feel that the proposed standard is correct to note in paragraph 9 that the indicators provided in paragraph 8 are not exhaustive. We therefore disagree that the list of indicators of impairment included in paragraph 8 of the Exposure Draft will always result in an enterprise estimating the recoverable amount whenever there is a significant risk that the asset is impaired, but would not wish to add any further indicators.

We are concerned with the possible frequency for review implied by the inclusion in the indicators of such items as a change in interest rates. At times, and frequently in some countries, this would impose on companies an onerous degree of work.

It would be helpful if the standard clarified whether the indicators of impairment should be considered by reference to the CGU as a whole where cash flows for assets within that unit cannot be assessed individually.

Paragraph 8(a) gives, as a possible indicator of impairment, 'an asset's market value has declined significantly more than would be expected as a result of the normal process of depreciation'. The combination of mandated review if an indicator exists of impairment (para 7) and this indicator might require review on a regular basis for businesses whose principal assets suffer an immediate large drop in market value - eg motor vehicles. Perhaps 8a could be amended to refer to 'normal use in the business', rather than to 'the normal process of depreciation (amortisation)'.

Net Selling Price

Q9 Do you agree that net selling price should be determined:

- a Based on "the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties" and that it is not necessary to determine net selling price by reference to an active market (paragraphs 5 and 17-18 of the Exposure Draft and paragraphs 31-38 of the Basis for Conclusions); and

Yes, it is possible that there may not be an active market as such but it will almost always be possible to estimate an arm's length price.

- b After deducting from the amount obtainable from the sale of an asset the incremental costs that are directly attributed to the disposal of the asset (excluding finance costs and income tax expense) (paragraphs 5 and 19-21 of the Exposure Draft and paragraph 35 of the Basis for Conclusions)?

We agree that directly attributable incremental costs of sale should be included in the calculation of NSP. However, we disagree with the exclusion, from such costs, of tax. The taxation effects of the ownership and use of an asset are fundamental to the realisation of its value by use or sale. As such, cash flows arising from taxation should be taken into account in determining the net selling price of the asset.

Value in Use

Q10 Do you agree with the proposed requirements and guidance in the Exposure Draft for:

- a The basis for estimates of future cash flows (paragraphs 23-27 of the Exposure Draft and paragraphs 24 and 40-42 of the Basis for Conclusions);

Yes, generally. However, we are concerned that the approved forecasts referred to in paragraph 23(b) may include costs of reorganisations or redundancies in respect of which the entity has no present obligation. Their inclusion would appear to conflict with the proposals of the Draft Statement of Principles on Provisions and Contingencies, and effectively permit provision to be made sooner than those proposals envisage. If paragraph 28(b) is intended to prohibit their inclusion, we consider this should be set out and explained much more clearly.

10b The composition of estimates of future cash flows (paragraphs 28-35 of the Exposure Draft and paragraphs 43-46 and 50-58 of the Basis for Conclusions); and

For the same reasons as we note in answer to question 9, other than the exclusion of tax cash flows, yes.

c Selecting the discount rate (paragraphs 36-40 of the Exposure Draft and paragraphs 47-49 of the Basis for Conclusions)?

We agree with the use of risk adjusted discount rates. However, as we note above, we believe that recoverable amount should be measured after tax since the amount paid for an asset will take into account the anticipated tax cash flows. We believe that preparers should be allowed to use pre-tax cash flows and pre-tax discount rates only where the effect is not material (eg, all cash flows bear tax at the same rate).

Cash-Generating Units

Q11 Do you agree that, if an asset does not generate cash inflows that are largely independent of those from other assets, an enterprise should determine the recoverable amount of the asset's cash-generating unit (paragraphs 46-47 of the Exposure Draft)?

Yes, and we believe that this is likely to be the more usual situation.

Q12 Do you agree with the requirements and guidance for determining the items that are included in a cash-generating unit (paragraphs 5 and 48-53 of the Exposure Draft)?

Yes.

Q13 Do you agree with the requirement (and related guidance) to recognise and measure an impairment loss if there exists goodwill or other corporate assets (such as head office assets) that relate to a cash-generating unit (paragraphs 59-61 of the Exposure Draft and paragraphs 79-81 of the Basis for Conclusions)?

Yes.

However, those paragraphs appear to be doing no more than explaining, in a somewhat different way, that goodwill is an asset like any other, that the recoverable amount of the appropriate CGU should be tested in the normal way and that the appropriate CGU may be larger than for other, allocable, assets.

We *do* find the additional explanation helpful, particularly as it refers explicitly to head office assets and is equally applicable to any asset that spans a number of CGUs. We therefore

support its inclusion in the final standard, but preceded by a comment along the lines of, 'goodwill is an asset like any other and is therefore subject to impairment review'.

Q14 Do you agree with the procedures for allocating an impairment loss of a cash-generating unit between the assets of that unit (paragraphs 62-65 of the Exposure Draft and paragraphs 77-78 of the Basis for Conclusions)?

Yes.

Disclosure

Q15 Do you agree with the disclosure requirements in paragraphs 79-81 of the Exposure Draft and that an enterprise should not be required to disclose more information, such as the amount of impairment losses that can be reversed in subsequent periods (paragraphs 88-92 of the Basis for Conclusions)?

Yes.

Q16 Do you agree with the disclosure requirements in paragraph 82 of the Exposure Draft and that an enterprise should not be required to disclose for each individual asset (or cash-generating unit) for which significant impairment losses have been recognised or reversed during the period:

- a The value in use of the asset (cash-generating unit) if the recoverable amount is based on the net selling price of the asset (cash-generating unit);*
- b The net selling price of the asset (cash-generating unit) if the recoverable amount is based on the value in use of the asset (cash-generating unit):*
 - i the discount rate(s) used in the calculation; and*
 - ii the assumed long-term average growth rate for the products, industries, and country or countries in which the enterprise operates or for the market in which the asset (cash-generating unit) is used; and*
- d Other key assumptions used to determine the recoverable amount of an asset.*
(paragraphs 24, 93-95 and 98-99 of the Basis for Conclusions)?

We believe that the disclosures required by para 82 may lead to a statement of excessive length and provide information whose disclosure is not really justifiable. Where there is a detailed measurement standard in place, as this would be, detailed disclosure is not necessarily appropriate. In addition, the disclosures in para 82 may be commercially sensitive. We would propose that only the requirement of paragraph 82(b) be retained, and that even that should be required only by class of asset.

We agree that the additional disclosure shown in question 16 should not be required.

Q17 Do you agree with the disclosure requirements in paragraphs 83-84 of the Exposure Draft and that an enterprise should not be required to disclose information similar to that proposed in question 16 above for each individual asset (cash-generating unit) for which:

- a Recoverable amount has been determined during the period;*
- b no impairment loss was recognised or reversed during the periods; and*
- c A small change in key assumptions could lead to the recognition or reversal of a significant impairment loss?*

(paragraphs 24 and 96-97 of the Basis for Conclusions)?

We consider the disclosures proposed in paragraphs 83-84 quite unnecessary. Provided that the impairment assessment has been properly carried out as required by the future standard, we can see no reason for disclosure that this has been done if the outcome supports the existing carrying values.

We agree that the additional disclosures set out in this question and question 16 should not be required.

Q18 Do you agree with the disclosure requirements in paragraph 85 of the Exposure Draft (paragraphs 24 and 100-101 of the Basis for Conclusions)?

No, preparers should be required to follow the procedural requirements of this paragraph but we see no benefit to the proposed disclosure. On this basis, the paragraph should be moved from the disclosure section of the standard to the measurement section.

Q19 Do you agree that an enterprise should not be required to give information on how cash-generating units are determined (paragraphs 102-105 of the Basis for Conclusions)? If you believe that such information should be required, please indicate which details should be required.

Yes.

Q20 Should an enterprise be required to disclose any information other than that discussed in questions 15-19 to this Invitation to Comment?

No.

Appendices

Q21 Should any material in Appendix 1 be amended or deleted? Should any further guidance be added to the appendix? (Note: the Board does not intend to publish appendix 3, Basis for Conclusions, with the final Standard.)

We do not believe that worked examples are essential for a proper understanding of the proposed standard. However, we would not object to their inclusion, in the proposed standard, by way of a guidance note.

Q22 Do you agree with the consequential changes to IAS 16, Property, Plant and Equipment (Appendix 2, Proposed Amendments to Other International Accounting Standards)?

We agree that IAS 16 should be changed so as to be consistent with the new impairment standard. However, as noted above under our answer to question 5, some of the changes proposed would no longer be required if the impairment standard is finalised as we suggest.

Other Comments

Q23 Do you have any other comments on the proposed International Accounting Standard?

Time periods for cash flow forecasts

It is clear that, in the simple case of a single asset, cash flow forecasts need only be prepared as far as the end of the individual asset's useful life. However, in the case of a cash generating unit, the appropriate period is less clear. Therefore, we would request that the final standard provides practical guidance as to the time period for which forecasts of future cash flows need be prepared.