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BOARD**

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Ms Laurence Rivat
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Dear Laurence

E55 'Impairment of Assets'

Noted below are some comments on E55 'Impairment of Assets'. I am sorry that they are a few days late. Please note that they have not been reviewed by the Board and, hence, do not represent a formal Board view.

I strongly support the basic approach set out in the exposure draft, in particular the measurement of recoverable amount as the higher of net selling price and value in use. This is the approach adopted by the Board in FRED 15 'Impairment of Fixed Assets and Goodwill', which sets out the following reasoning behind its proposals:

The FRED proposes that an impairment should be measured by comparing the carrying amount of a fixed asset or income-generating unit with its recoverable amount. The recoverable amount is based on the cash flows that can be generated by the fixed asset or income-generating unit either by sale (net realisable value) or by continued use (value in use). By writing down the fixed assets or goodwill to the higher of the amount that can be recovered through sale or continued use, the fixed assets or goodwill are recorded at their greatest value to the entity. If the entity chooses not to use or sell the fixed asset or income-generating unit so as to recover the greatest value possible, the loss from not doing so is properly recorded in the period in which the fixed asset or income-generating unit is sold when more could be recovered through use, or in the period(s) in which it is used when more could be recovered through sale.



The Board believes that this presents a faithful representation of the economic decisions that are made when a fixed asset or income-generating unit becomes impaired.

An alternative approach would be to measure impairment by reference to fair value. This is the approach adopted by the US standard FAS 121 'Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of'. The Board does not support this approach because it relies heavily on there being an active market for the asset in question, which there may well not be for many fixed assets. It also does not take account of the fact that an entity's specific circumstances may enable it to recover more from an asset than most participants in the market. (*FRED 15, Appendix III, paragraphs 6-8*)

There are only two other issues on which I wish to comment: the treatment of tax and the allocation of impairments in cash-generating units in which an acquired business has been merged with an existing business.

Tax

E55 proposes that recoverable amount should be measured on a pre-tax basis, and that any tax consequences should be reflected in accordance with IAS 12. It seems to me that there are a number of problems with this approach. The amount that the entity will finally recover from an asset will be a post-tax amount. It would, therefore, be wrong to ignore the effects of tax in calculating impairments. Reflecting the tax effects by applying IAS 12 to a pre-tax figure does not always achieve the desired effect.

The first problem is that comparing net selling price and value in use on a pre-tax basis may lead to recoverable amount being based on the wrong measure. For example, suppose that the pre-tax net selling price was £900 on which a balancing tax charge of £111 was payable and that the pre-tax value in use was £950 with expected tax payable of £200. On a pre-tax basis, recoverable amount would be based on value in use of £950 but in fact the entity can recover more by selling the asset and recovering a net amount of £789 (£900-£111) rather than using the asset and recovering £750 (£950-£200). The tax effect needs to be considered in determining the basis for recoverable amount—applying IAS 12 to the recoverable amount determined on a pre-tax basis brings in the effect of tax too late in the calculation.

The next problem occurs when value in use is the appropriate measure on which to base recoverable amount. Calculating value in use on a pre-tax basis and then applying IAS 12 does not necessarily give the same net figure as calculating value in



use on a post-tax basis. The reason for the difference is that under IAS 12, any capital allowances still to be received on the asset are not discounted whereas in calculating a post-tax value in use all cash flows are discounted. Given that it has been agreed that recoverable amount should be based on discounted figures, it is inconsistent not to discount the tax effects.

The final problem is that to arrive at a pre-tax value in use, the pre-tax cash flows should be discounted at a post-tax discount rate. E55, however, requires the pre-tax cash flows to be discounted at a pre-tax discount rate. This gives a post-tax value in use (the same value can be determined by discounting the post-tax cash flows at a post-tax discount rate). E55 is, therefore, double counting the tax effect, once in the calculation of value in use and then again in applying IAS 12 to that post-tax figure.

The approach taken in FRED 15 avoids these problems by calculating net selling price and value in use on a post-tax basis and then splitting the net figure into pre-tax and tax elements for presentation in the financial statements.

Allocation of impairment when an acquired business is merged with an existing business

FRED 15 proposes that, where an impairment occurs in a cash-generating unit that contains an acquired business that has been merged with an existing business, unrecognised internally generated goodwill in the existing business at the time of the acquisition should be taken into account in the allocation of the impairment. The proposal is discussed in paragraphs 79-81 of Appendix 3 to E55 but rejected on the grounds that it would be costly and difficult, or even impossible, to distinguish items related to internally generated goodwill from those specific to the assets.

The proposals in FRED 15 recognise that it is not possible to distinguish cash flows that arise from internally generated goodwill from those arising from assets in the cash-generating unit. What the proposals do is to estimate the internally-generated goodwill in the existing business at the time of the acquisition and to allocate some of the subsequent impairment to that internally generated goodwill. It is, of course, not a perfect solution—the pro rata allocation can be regarded as arbitrary. Nonetheless, it seems a better solution than ignoring the internally-generated goodwill altogether. Without some such requirement, most acquisitions that are merged into existing profitable operations would never suffer a write-down even if the acquisition was, in fact, a failure.



I hope that these comments are of help. Please let me know if there is anything arising that you would like to discuss.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Anne', is positioned above the printed name.

Anne McGeachin
Project Director