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The Secretary-General  
International Accounting Standards  
Committee  
167 Fleet Street  
London EC4A 2ES  
United Kingdom

Dear Sir

**Exposure Draft E55: Impairment of assets**

We welcome this opportunity to comment on the above Exposure Draft. Our comments first deal with general issues of principle which we would like to raise, and thereafter deal with the specific questions on which the Board has sought answers. In drafting our comments we have taken account of the remarks made by the representatives of the Member States of the EU in the Technical Sub-Committee of the Contact Committee on the Accounting Directives. However, our comments do not necessarily reflect the unanimous views of all Member States.

Before addressing the specific questions on which the views of commentators are sought, we make some general comments, which are set out below.

**1. GENERAL ISSUES OF PRINCIPLE**

We have the following general concerns about the overall approach of the Exposure Draft which, we believe, need to be addressed before it can be converted to an International Accounting Standard:

- ◊ We are concerned that some might see impairment to be a surrogate for amortisation, since E55 is not sufficiently clear that the impairment exercise is something to be performed over and above the normal operation of allocating costs over the useful economic life of an asset. This is of particular importance given the fact that E60 is proposing that there should be no ceiling on the useful life of assets such as goodwill and research and development.

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- Some of the proposals are premature in the sense that they presume a consensus on more fundamental issues that does not in fact yet exist (for example, the role of discounting in financial statements) and may imply changes to existing practice that are more far-reaching than may generally be realised.
- The proposals may give a false sense of security to users of accounts. Whilst the methodology for calculating impairment appears to be objective, the reality is that the proposals are not as robust as they may appear and the assumptions underlying the impairment calculation in any particular case will be highly subjective and manipulable. At the same time, though, we are aware that the Board is currently field testing E55's proposals, and we welcome this course of action. This is because we are concerned that a large proportion of companies who may wish to apply International Accounting Standards are not geared up to measure impairment in the way envisaged by E55. Moreover, companies which are unfamiliar with the concepts which underlie E55 might find the proposals confusing or even ambiguous. Consequently, we hope that the results of the field tests will either allay our concerns or persuade the Board to provide more clarity as to how the impairment test is to be applied in practice.

These concerns are elaborated upon below.

### *1.1 Lack of clarity on the objective of impairment*

The initiative of the Board in proposing a standard which specifies how impairments are calculated should be welcomed. However, the current Exposure Draft does not state with sufficient clarity that the impairment procedure is to be applied to assets only after the depreciation/amortisation procedures have been applied. Moreover, the concept of Cash Generating Unit, on which the whole ED is based, introduces a high level of subjectivity. Both these considerations cast doubt on whether the IASC merely wants to confine itself to defining the characteristics of the impairment review and the way it should be carried out, and could raise a suspicion that E55 aims to introduce a new method of valuation to be performed in dissociation from the depreciation/amortisation procedure.

### *1.2 Proposals more far-reaching than may be realised*

Currently, the future recovery of fixed assets is normally assessed at the operating profit level, without allowance for costs of finance, the objective being to avoid reporting future operating losses where they would arise through an inability to recover the normal charge for depreciation of the assets. In contrast, the exposure draft proposes that impairment should be measured by discounting the future cash flows expected to flow from the asset. Although there are sound economic arguments for this proposal, it would be a major change of practice.

One of the possible effects of the IASC's proposed approach is that any company which anticipates a return on capital below a market rate of interest and identifies sufficiently large "Cash Generating Units" will recognise a loss. This means, in principle, that a general rise in interest rates can trigger asset write-downs, even though the underlying trading performance of the enterprise remains unchanged. Financial reporting is not necessarily improved if all companies avoid reporting sub-standard results by pre-emptive write-downs. It is one thing to provide for anticipated losses (which, ironically, standard setters throughout the world, including the IASC, are seeking to curtail) but

quite another to provide for the absence of 'adequate' profits. To do so gives a potentially misleading view of the true ongoing profitability of a business in a declining industry which was still earning some return on its assets, but not making enough to constitute a reasonable return.

### *1.3 Proposals are not as robust as they may appear*

There must be a concern that users of accounts will place more reliance on the fact that assets have been subject to an impairment review than is justified by the reality. The methodology may in many ways be described as 'pseudo-science', in that it involves quite complex mathematical manipulation of extremely subjective data. Experimentation with basic models quickly demonstrates that the results of any impairment review are extremely sensitive to even small changes in assumptions as to any one of the following:

- (a) composition of the cash-generating unit; (see also our responses to Questions 4 and 19 below);
- (b) allocation of goodwill and central costs;
- (c) level and incidence of future cash flows; and
- (d) discount rate chosen.

Anyone with experience in business forecasting will know that forecasts often tend to be made on the basis that positive trends will continue for the foreseeable future and negative trends will soon reverse. It is also well known that forecasts are based on assumptions and assumptions comprise a large measure of guesswork and hope. This being the case, there can be little doubt that companies will be able to choose, from the range of possible assumptions, those which yield the 'right' result. In fact, these concerns clearly underlie paragraphs 83 and 84 of the exposure draft, which require that entities disclose when they have performed an impairment review that has not resulted in assets being written down, and encourage disclosure of assumptions to which the final outcome of the review is highly sensitive. To propose such a disclosure is effectively saying either that the test is not particularly reliable (in which case, its cost/benefit implications should be considered seriously), or that reporting entities cannot be relied upon to perform it, or their auditors to review it, conscientiously.

## **2. ANSWERS TO SPECIFIC QUESTIONS**

Our responses to the specific questions raised in the exposure draft are as follows.

### *Question 1 Basis of determining recoverable amount*

We support option (a). However, we believe that there is the need for the concept of 'net selling price' to be given greater clarity, particularly in those exceptional cases where it is higher than the value in use.

### *Question 2 Use of discounting*

As noted in our general comments above, we do not believe that this can be considered in isolation of a consensus on the role of discounting in general. It is also noteworthy that discounting is not used in Canada and is also questioned in the United States. We also

note that FAS 121 requires an initial test based on undiscounted cash flows, and discounting is only applied when this test is failed.

*Question 3 Asset held for disposal*

Yes. At first sight the suggestion that assets held for resale should be valued at 'value in use' rather than NRV seems counter-intuitive, but the reasoning in paragraph 26 admirably explains why it is valid. However, it is important that paragraph 26 should be retained somewhere in the final IAS.

*Question 4 Recognition of impairment loss*

There is an apparent inconsistency between the wording of this question and the requirements of the proposed IAS. The question implies that there is always a choice of treating assets singly or as part of a larger cash-generating unit, whereas the exposure draft permits aggregation only where it is impossible to project cash flows for individual assets. In principle, we support the approach in the exposure draft. The difficulty is that, in practice, it will nearly always be possible for management to argue that some form of aggregation is necessary. Once aggregation occurs, it may be easy to 'cover' impairment losses that would otherwise arise on some assets in an assessment of a larger unit.

*Questions 5 Reversals of impairment losses*

A key 'estimate' in the impairment review is the choice of discount rate. The effect of the proposed treatment could therefore be to mark fixed assets up and down as a result of general interest rate changes. As noted in our general comments above, we have serious reservations as to whether this is appropriate. Furthermore, we believe that there is the need for clarification of the phrase 'a change in the estimates' in paragraph 70. In particular, what would happen when one year the value in use is higher than the selling price and the year after the position is the reverse (but always below the carrying amount)? Should a reversal be recognised?

*Question 6 Reversal of impairment losses (goodwill and certain intangibles)*

Yes. However, in our view clarification is required as to what constitutes an 'external event': for example, should the discount rate be considered an external event?

*Question 7 Scope of proposed IAS*

We have no particular difficulty with this although, as noted above, it does undermine the IASC's reasoning for undertaking the project. It also raises questions as to whether the proposed standard should be specifically tailored to deal with unique issues surrounding accounting for intangibles.

*Question 8 Identification of impairment*

Yes.

*Question 9 Estimation of net selling price*

Yes.

*Question 10 Estimation of value in use*

In principle, yes. However, please see our general comments above on the inherent subjectivity of the assumptions involved and on the effect of discounting. In particular,

we believe that the (relatively simple) example in paragraph 29 illustrates how difficult it will be to apply the proposed standard in practice. We consider that the guidance on the selection of the discount rate is hypothetical and of little practical help to preparers and auditors as to how they should, in practice, select the appropriate rate.

*Questions 11 to 14*

As literally drafted, the provisions of the draft standard are fairly unobjectionable. The problem is, as noted in our general comments above, that in many cases they rely on highly subjective decisions. Whether it is 'possible' or 'impossible' to assess the cash flows of an asset in isolation, or 'necessary' to include certain liabilities in a cash-generating unit, will often be matters of (quite legitimate) debate.

*Question 15 Disclosures in paragraphs 79-81*

Yes.

*Question 16 Disclosures in paragraph 82*

It could be quite cumbersome, and commercially sensitive, to make these disclosures on an asset-by-asset (or even a unit-by-unit) basis. Some aggregation must be allowed. The disclosure required by paragraph 82(d)(iii) (and, to some extent by the rest of paragraph 82(d) and 82(c)) appears to reflect an implicit assumption that value in use should not be materially different from net selling price, which contradicts the overall approach of the proposed standard.

*Question 17 Disclosures in paragraphs 83 and 84*

As noted in our general comments above, the proposed disclosures in these paragraphs suggest that the IASC has doubts either as to the validity of the impairment review or as to the integrity of management and auditors. If this really is the case, the solution is to reconsider the whole approach of the proposed standard – not to require disclosures which could have the effect of conveying to the markets a lack of confidence in the impairment test, the way management have implemented it and the way that the auditors have audited it. Accordingly, assuming that there is no fundamental change to the overall approach of the exposure draft, we see no merit in retaining paragraphs 83 and 84.

*Question 18 Disclosure in paragraph 85*

No. The first part of this paragraph is, in fact, concerned with measurement rather than disclosure. The actual disclosure part of the paragraph seems to be aimed at (in effect) highlighting how good or bad the reporting entity is at forecasting, but it is not clear to us what purpose is served by disclosure of what prior year results would have been had forecasting been more accurate.

*Question 19*

We strongly disagree with the Board's view that no disclosure should be made of how cash-generating units are defined. Indeed, given the somewhat excessive proposed disclosures of other matters, to omit this verges on the perverse, since in many cases it is the choice of cash-generating unit that has the most significant outcome on the result of any impairment review. We would propose that a reporting entity should disclose either what its cash-generating units are or, as a minimum, give an indication of how they are determined (e.g. by type of business, geographically, outlet by outlet etc.), together with an indication, and explanation, of any changes from the previous period.

*Question 20*

Other than indicated in our response to Question 19 above, no.

*Question 21*

On balance, we believe that Appendix 3 should be retained in the final version of the standard. The requirements of the proposed IAS will be a major change to existing practice for many entities and more guidance will be needed to clarify the IASC's thinking than might be the case on a less radical new standard.

*Question 22*

Yes.

*Question 23*

We would once again ask the Board to consider seriously the impact that this exposure draft, if converted to a standard, will have on financial reporting under IAS. In our view the proposals are not nearly as robust as they may appear, with the result that they will introduce an unacceptably high degree of subjectivity, manipulability and unreliability in the measurement of fixed assets.

We would be pleased to discuss in more detail with the Steering Committee any of the matters which we have raised in this response.

Yours faithfully



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Head of Unit