



Institute of
CHARTERED ACCOUNTANTS
of New Zealand

16 September 1997

The Secretary-General
International Accounting Standards Committee
167 Fleet Street
London
EC4A 2ES
UNITED KINGDOM

Dear Sir Bryan

E55: IMPAIRMENT OF ASSETS

Please find attached the Institute of Chartered Accountants of New Zealand's submission on the International Accounting Standards Committee (IASC) proposed International Accounting Standard E55: *Impairment of Assets*.

We appreciate this opportunity to comment on E55 from a New Zealand perspective. If you have any questions do not hesitate to contact me.

Yours sincerely

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**SUBMISSION TO THE
INTERNATIONAL ACCOUNTING STANDARDS
COMMITTEE
ON
E55:
*IMPAIRMENT OF ASSETS***

Prepared by
The Institute of Chartered Accountants of New Zealand

16 September 1997

INTRODUCTORY COMMENT

The Accounting and Professional Standards Department of the Institute of Chartered Accountants of New Zealand has considered E55: *Impairment of Assets*. We appreciate the opportunity to comment on the proposed International Accounting Standard.

We consider that it would be useful for the standard to explain better the objective of accounting for impairment of assets. At present, the "Objective" paragraph (page 13 of E55) states merely that the objective is "to prescribe the accounting treatment for an asset that is impaired and the consequences of such an impairment". The paragraph then explains that an indication of potential impairment should lead to estimation of recoverable amount, and if recoverable amount is less than carrying amount then an impairment loss should be recognised.

However, the underlying reasons for carrying out the above procedures are not explained. We consider that such an explanation would be desirable to ensure that the impairment debate remains focused and the final prescription provides the best solution for achieving the underlying objective. There is a risk that if the objective is lost sight of, then the best solution for accounting for impairments may not be chosen.

In our view, the underlying objective of this standard is to ensure that carrying amounts of assets are not overstated. Assets are overstated when they are carried at amounts in excess of what is supportable in terms of cash flows: the fundamental question to be asked is, "Can the carrying amount of the asset be recovered through future cash flows?", or "Is the carrying amount of the asset underpinned by a sufficient level of cash flow?". Recovery can be achieved through using or selling the asset. We therefore need to be sure we can justify the carrying amounts of assets in terms of the cash flows that the assets could generate.

"Recoverability" concerns the amount that *could* be generated - the amount that is *able to be recovered*. It is therefore independent of management intent and of the probability of recoverability in a particular fashion. For example, the fact that management might have no intention of selling an asset, or the low probability of the sale of an asset, would not preclude the net selling price from being the legitimate recoverable amount, if it were higher than value-in-use.

The above-stated objective is central to the views put forward in this submission. We consider it should be incorporated into the future impairment standard's paragraph on "objective" so that the rationale for the final prescription can be more fully understood by the constituency.

Having made the above point, the emphasis on cash flows could cause difficulties in respect of assets held by public sector entities and not-for-profit entities. We note that E55 does not deal with situations in which assets do not generate cash flows. This is an important issue in New Zealand, where financial reporting standards cover both the public and private sectors. Therefore, financial reporting standards in New Zealand need to accommodate assets (typically in the public sector) that either do not generate cash flows or are not used primarily for cash-flow generation. Perhaps the proposed impairment standard should highlight the fact that it does not address the impairment of non-cash-generating assets.

QUESTIONS RAISED

1. 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)?

- 1.1 We agree with option (a) and reject options (b) and (c).

Options (a) and (b) accept the use of market values, although the "fair value" option under (b) does not take into account the costs of disposal of the asset. However, it is not difficult to justify a definition of "fair value" that incorporates disposal costs. We consider that disposal costs should be deducted from market values to reflect the "recoverability" value of the asset, as described in our introductory comment. Similarly, both (a) and (b) accept the use of present value approaches.

- 1.2 The difference between options (a) and (b) is the way in which the options are structured. Option (a) requires the recoverable amount to be *the higher of* net selling price and value-in-use, whereas option (b) requires recoverable amount to be the market price (if that exists) and value-in-use *only if* the market price cannot be established.

We reject option (b) as we see no rationale for defaulting to value-in-use only when there is no market for the asset. Option (b) would require that in instances of impairment where both premises of value can be established, and the value-in-use is higher than the market value, the asset will be written down to an amount that is below its measurable level of recoverability.

- 1.3 An assertion is made in the first paragraph on page 4 of E55, that "Those who favour a 'fair value' approach are likely to see it as a more reliable measure of recoverable amount ...". The issue of reliability is given paramount importance in asset recognition, in our *Statement of Concepts for General Purpose Financial Reporting*. Value-in-use will be reliably determinable in some instances and not in others; where it can be reliably determined and is higher than market value it should constitute the recoverable amount.

- 1.4 Regarding the meaning of selling price, we consider the standard should make explicit the fact that in situations in which an asset *cannot* be sold (e.g. for regulatory reasons) there is no selling price.
- 1.5 We do not support any other approaches to establishing the recoverable amount (part (c)).

2. **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)?**

- 2.1 We agree that present value techniques should be used to measure the recoverable amount of an asset, implicitly (net selling price) and explicitly (value-in-use). As stated in our response to Question 1, we do not consider that the issue of reliability weakens the case for present value techniques; standards of reliability must be met whichever valuation base is used. If present values (and similarly, market values) are unreliable then they should not form the basis of recoverable amount.

Assets Held for Disposal

3. **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)?**

- 3.1 We agree with the definition of recoverable amount in paragraph 5.

Recognition of Impairment Losses

4. 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
 - (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)?
- If you disagree with these proposals, please indicate criteria you would prefer for the recognition of an impairment loss in the financial statements.

- 4.1 We agree in principle to the impairment loss recognition criteria stated in paragraphs 41 and 55-58 of the Exposure Draft. We consider that the cash-generating unit concept is necessary to fulfil the objective of impairment accounting.

The use of the cash-generating unit overcomes situations in which an asset has a low net selling price (which is measurable) and a high value-in-use which is not measurable in isolation from other assets. In such a situation, it would be untrue to say that the asset is impaired to the level of the net selling price. The cash-generating unit approach recognises that any impairment loss should be limited to the recoverable amount, which is based on the asset's ability to contribute to future cash flows.

- 4.2 Notwithstanding our support for this approach, we consider that this could present opportunities for manipulation of impairment write-downs. This can occur through the defining and redefining of cash-generating units. Also, the use of the cash-generating unit could be used to cover up or "net off" compensating rises and falls in the recoverable amounts of assets within the cash-generating units.

Not enough emphasis has been given in the examples in E55 of "pushing down" the cash-generating unit to the lowest possible level. Instead, examples are given of where the cash-generating unit could constitute the entire business. We would prefer to see more emphasis on the need to "push down" as far as possible when identifying the cash-generating unit.

- 4.3 We note that the notions of recoverable amount, and particularly identification of the cash-generating unit, may be problematic for assets that do not generate cash flows or are employed primarily for reasons other than cash generation. (Please refer to our introductory comment.)

Reversals of Impairment Losses

5. 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)?
6. 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)?

5/6.1 We have addressed the two possible reasons why we might wish to reverse an impairment: a change in estimate only (i.e. no change in underlying events) and a change in estimate based on a (whole or partial) change in the event that caused the impairment. These scenarios, and our views on the treatment for tangible assets, intangible assets, and goodwill, are illustrated in the following table.

REVERSALS OF IMPAIRMENT LOSSES			
	<i>Tangible assets</i>	<i>Intangible assets</i>	<i>Purchased goodwill</i>
Revision of estimate (no change in underlying events)	✓	✓	✓
Reversal of causal event	✓	✓	✓

5/6.2 We consider that the treatment of intangible assets should be consistent with that of tangible assets. The tangibility-intangibility distinction does not of itself justify a different treatment, and we see no reason why a distinction should be drawn for the purpose of impairment reversals. The fundamental bases of accounting for tangible and intangible assets are the same: identical principles apply for the purposes of definition, recognition, valuation and depreciation.

5/6.3 We are aware of no reason why a revision of estimate only should not be reversed for all assets including goodwill. A revision of estimate occurs because the entity now has a better set of information about the original set of circumstances. Revising estimates ensures that the financial statements present information that is more relevant, meaningful and accurate than before. Conversely, failure to revise estimates when better information is available would constitute a failure to show the more true and fair view of financial position. For purchased goodwill, a reversal due to a change of estimates does not equate to capitalising internally-generated goodwill; it is a change of estimate relating to the originally purchased goodwill.

5/6.4 We agree that impairment loss reversals should be recognised for all assets (including goodwill) where those reversals stem from (whole or partial) reversals of the external events that caused the original impairments. We note that this process is one of reversing impairments and should not be confused with revaluations. If the original impairment was the result of an external economic event, then a reversal of that economic event should also be reflected in the financial statements for the statements to remain meaningful.

Scope

7. 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)?

7.1 We agree with the scope of the Standard as listed in paragraph 1 of the Exposure Draft.

Identifying a Potentially Impaired Asset

8. 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).

8.1 We agree with both propositions (a) and (b) but are not happy with the wording of paragraph 7. We consider that the two-step approach is correct:

1. Consider whether there is any indication that an asset may be impaired, and if so;
2. Establish the recoverable amount and impairment loss (if any).

However, we believe that the wording could be improved to emphasise that, if there is no indication of impairment, the entity is not obliged to review the assets' recoverable amounts. A suggested wording is as follows:

7. *At each balance sheet date, an enterprise should assess whether there is any indication that an asset might be impaired. If there is no indication of impairment, then the enterprise is not required to estimate the recoverable amount of the asset. However, if any such indication exists, then the enterprise should estimate the recoverable amount.*

Net Selling Price

9. 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
 - (b) after deducting from the amount obtainable from the sale of an asset the incremental costs that are directly attributable 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)?

- 9.1 We agree with the propositions in parts (a) and (b) of question 9.
- 9.2 We consider that the word “estimated” should be inserted in the definition of net selling price in paragraph 5 of the Standard, so that the definition reads “*Net selling price is the estimated amount obtainable from the sale of an asset . . .*”. This amendment would more correctly describe the nature of net selling price.
- 9.3 With regard to part (a), we do not believe that an active market is necessary to determine a selling price. If a selling price can be determined in a thin market, it is a selling price nonetheless, and it can provide a reliable measure of the cash flows that could be recovered through sale of the asset.
- 9.4 With regard to part (b), we agree to the deduction of disposal costs. Failure to deduct disposal costs overstates the cash flows that the asset can recover through sale. (Refer to our comments on Question 1.)

Value in Use

10. 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);
 - (b) 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
 - (c) selecting the discount rate (paragraphs 36-40 of the Exposure Draft and paragraphs 47-49 of the Basis for Conclusions)?

10.1 We agree in principle with paragraphs 23-27 of E55. However, New Zealand accounting standards distinguish between “forecasts” and “projections”, and hence we would not use these terms interchangeably. The New Zealand standard FRS-29: *Prospective Financial Information* defines “forecast” and “projection” in paragraphs 4.1 and 4.2 respectively, with commentary in paragraph 4.3. We consider that the distinction is useful.

4.1 *“A forecast” means prospective financial information prepared on the basis of assumptions as to the future events that the governing body reasonably expects to occur associated with the actions the governing body reasonably expects to take as at the date that the information is prepared (best-estimate assumptions).*

4.2 *“A projection” means prospective financial information prepared on the basis of one or more hypothetical but realistic assumptions, (or “what-if” scenarios), that reflect possible courses of action for the reporting periods concerned as at the date that the information is prepared.*

4.3 *Forecasts reflect the most probable outcome while projections reflect a range of possible outcomes. The date that the information is prepared is the date when the prospective financial information is approved by the governing body of the entity reporting, or otherwise authorised, for issue.*

We would use the word “forecast” in place of “projections” in paragraph 23(a).

10.2 We see no necessity for subparagraphs (b) and (c) to be in black letter. Subparagraph (a) is sufficient in stating the standard requirement and should remain in black letter. However, (b) and (c) offer guidance, including certain “out” clauses (e.g. “unless a longer period can be justified” and “unless a higher rate can be justified”), and as such, it is more appropriate that they be in grey letter.

10.3 We agree with the propositions in Question 10 (b) and (c). Although we recognise that the choice of discount rate is a matter for debate, we do not consider that alternative approaches are necessarily any better.

Cash-Generating Units

11. 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)?

- 11.1 We agree with this proposition, subject to our concerns expressed in our response to question 4.

12. 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)?

- 12.1 We agree with the requirements of paragraphs 48 to 53 but are concerned that the example given could be better. While the Exposure Draft exhorts users to identify cash-generating units at the lowest possible level, the bus company example illustrates a case where the company as a whole is the cash-generating unit.

In this example, the deemed cash-generating unit is the company, and not the individual routes or buses running the routes, even though the cash flows from each route can be identified separately. It appears that the justification for this is that the cash flows from each route are not independent of each other because the company must contract to serve all of the routes or none at all.

- 12.2 We are concerned at the implications of this reasoning, particularly for loss-leader situations. The Exposure Draft does not explicitly address the question of loss-leaders. We consider that the bus company example ought to be clarified and the loss-leader scenario addressed to avoid misunderstanding or abuse of this provision.

If the scenario in the bus company example is to be accepted, then we consider that a distinction should be drawn between loss-leaders that are carried for fundamental contractual reasons (e.g. the loss-making bus route) and loss-leaders that are carried only for strategic reasons. We consider that as the latter situation is one over which the management has discretion, the cash-generating unit should be identified at the lower level and the assets written down.

13. 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)?

13.1 We have no problem with this requirement.

14. 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)?

- 14.1 We recognise that paragraph 62 is dealing with allocation and believe the procedure to be arbitrary, whereby the impairment hits the traditionally more “troublesome” assets first. We do not consider there to be a strong justification for this policy but recognise that alternatives may not be any more supportable.

We note that the current subparagraph (c) refers to assets whose selling price is less than their carrying amounts. This is the only situation in the ranking where there is external evidence indicating that the recoverable amount might have fallen; yet these assets are ranked third for impairment, rather than first.

- 14.2 We are broadly in agreement with paragraph 62 but suggest an insertion in subparagraph (c) as follows:

(c) *thirdly, to assets whose net selling price is known to be less than their carrying amounts; and*

The inserted wording makes it clear that there is no requirement imposed on financial statement preparers to find out what the net selling prices are.

Disclosure

15. 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)?

15.1 We agree.

- 16. 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);**
 - (c) 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)?**

16.1 We agree with the requirements of paragraph 82(a)-(c).

16.2 We disagree with the requirements of paragraph 82(d)(i) and (ii) on the grounds that these disclosures are excessive. It is undesirable for financial statements to carry detailed disclosures about assumptions that underpin carrying amounts. Such detail of disclosure is generally not required for other assets where adjustments are made to carrying values for impairments (e.g. inventories, trade receivables). We believe that the concerns of financial statement users are met by both management (or governing body) assurances and auditors' verifications of asset carrying amounts.

16.3 We repeat our concern expressed in paragraph 14.2 of this submission, that where the recoverable amount is based on value-in-use, it should be clear that the entity is not required to find the net selling price also. Therefore we suggest a change in wording to paragraph 82(d)(iii) as follows:

(iii) if the net selling price is known to be significantly lower than the value-in-use, the fact that the value-in-use significantly exceeds net selling price.

16.4 In response to subparagraphs (a) - (d) of question 16, we agree that entities should not be required to make these disclosures. They place unnecessary burdens on preparers to disclose information of questionable benefit. If the net selling price can be reliably established as the recoverable amount, then the disclosure of value-in-use holds little relevance, and vice-versa. Our objection to the disclosure of detailed assumptions is expressed in paragraph 16.2 above.

- 17. 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 period; 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)?**

17.1 We disagree with these disclosure requirements for the reasons expressed in our response to Question 16. We believe them to be too detailed and of questionable benefit.

17.2 We are reminded that this Standard deals with impairment of asset carrying amounts, and not with revaluations *per se*. We see little merit in the additional information about value-in-use calculations when no impairment has been recognised. Accountants are generally not required to give negative assurances regarding fixed asset revaluations or when reviewing inventories in terms of the lower of cost or net realisable value. We do not believe that this Standard should set such a precedent.

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

18.1 We disagree with the disclosures proposed in paragraph 85 of the Exposure Draft. We consider that reversing impairments, or making further impairments, as a result of changes in estimates of future cash flows is sufficient for the purposes of this Standard. We see no merit in disclosing a comparison of forecasted and actual cash flows after the event.

- 19. 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.**

19.1 We disagree that enterprises should not be required to give this information. We consider that enterprises should be required to give an overall accounting policy on the determination of cash-generating units. More detailed disclosure would be useful in the sense that it may discourage potential abuse or, at least, offer some transparency. We have expressed our concerns on this issue (see our response to Question 4) and believe that the ability to manipulate results through the choice, and subsequent changes in choice, of the cash-generating unit can be partly addressed through such disclosures. We agree with the reasoning given in paragraphs 102 and 103 of the Basis for Conclusions.

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

20.1 We have no other comments on disclosure requirements, other than that the Statement of Accounting Policies should give a general description of the accounting policy relating to impairment of assets.

Appendices

- 21. 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.)**

21.1 No comment

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

22.1 We have no objection to the consequential changes to IAS-16: *Property, Plant and Equipment*. Regarding paragraph 30 of IAS-16 (the allowed alternative treatment of carrying assets at valuation), we assume that in the periods between those in which formal valuations are made, an entity may base the recoverable amount on value-in-use if it is higher than net selling price. This would be necessary to avoid placing an obligation on entities to formally value assets more frequently than is required.

Other Comments

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

23.1 We thank you for the opportunity to comment of E55 and appreciate your extension of the deadline for comment.