

July 23, 1997

TO: The Secretary General
International Accounting Standards Committee

FROM: Walter P. Schuetze



RE: Exposure Draft E55: Impairment of Assets

The Exposure Draft on Impairment of Assets should not be issued as a final standard for it is fatally flawed. The information produced by following E55, if issued in final form, would be unreliable and irrelevant and therefore misleading to investors.

The major flaw in E55 is that it requires that "value in use" be used to determine whether the carrying amount of an asset is impaired. To determine value in use of an asset, management of the reporting enterprise makes its own, private estimate of the future cash flows that the asset may produce--as contrasted to what unrelated third parties, i.e., market participants, would estimate as the future cash flows from that asset. Amounts in financial statements should--in order to be reliable--be based on information that is free from preparer bias. Thus, fair value of the asset, not value in use, should be used to determine whether the carrying amount of the asset is impaired, with fair value being the estimated amount of cash the asset would yield in a sale to an unrelated party, that is, a market participant. Fair value is an amount that generally can be verified by reference to information outside the enterprise and thus is reliable. Value in use, being an internal, private estimate, cannot be verified and thus is not reliable.

Indeed, at the time an asset is acquired by paying cash for the asset, the value in use of that asset to the buyer may be an amount in excess of fair value which is the amount of cash just paid for the asset. Were our accounting system one that allowed or required periodic revaluation of assets and were value in use a superior number to fair value in terms of its relevance to the reporting enterprise's investors, then we would see revaluations upward at the time assets are acquired whenever value in use is greater than fair value. I think that investors would not favor that idea.

Value in use of an asset to the holder of an asset is not a relevant amount to investors in the securities issued by the holder of the asset. The cost of an asset to the holder the asset is relevant to the holder's investors at the time an asset is acquired, for at the time of acquisition the cost of the asset is the best estimate by market participants of the present value of the cash that may flow from the asset. But, just as value in use to the holder of an asset is not relevant the holder's investors at the time the asset is acquired, neither is value in use relevant to those investors at some later date. Insofar as the holder's investors are concerned, the best

estimate of the present value of cash that may flow from an asset is what marketplace participants think that amount is, not what the holder of the asset thinks it is.

The holders of assets may do their own, internal, private accounting any way they want to; those holders of assets may decide what is relevant for their own, private purposes. But, the chief concern of the IASC is financial accounting and reporting for investors and creditors. The information that is produced for investors and creditors must be relevant to them, and the information must be reliable(verifiable). Value in use fails on both counts.

In the Invitation to Comment on E55, on page 5, it is stated that "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..." Wrong. That procedure requires the use of the same unreliable (and non-verifiable) information to estimate fair value as would be used to estimate value in use. An estimate of fair value requires the use of information external to the reporting enterprise.

For most assets, information regarding fair value of the asset or a similar asset is available from external sources at a relatively insignificant cost. This is true, for example, as to land, land leaseholds, office buildings, apartment buildings, automotive equipment, commercial aircraft, earth-moving equipment, on- and off-shore oil and gas drilling rigs, ocean-going vessels, mining equipment, mines, oil and gas reserves, unexplored oil and gas leases, taxicab licenses, fishing licenses, radio stations, TV stations, memberships on stock or commodity exchanges, copyrights, and patents. Even as to unique, one-of-a-kind assets, such as chemical processing plants and refineries, information from external sources about current input and output prices can be used by engineers and other knowledgeable people to estimate fair value of the asset. Only as a last resort, and then only when the cost of getting information from external sources is judged to be too high in relation to the benefit to investors, should a final standard allow for the use of internal, private information to estimate fair value; and, in that case, there should be a requirement for the reporting enterprise to disclose that the estimate of fair value was made based on internal information as opposed to external information.

I recommend that the final standard on impairment of assets require that fair value of an asset be compared to the carrying amount of the asset to measure impairment, and that to the extent possible within cost/benefit constraints that fair value be estimated by reference to information external to the reporting enterprise, and that there be required disclosure if the estimate of fair value is made by reference to information internal to the enterprise.

I incorporate by reference my three-page memorandum of March 12, 1997 to Ms. Rivat on the subject of impairment, a copy of which memorandum is attached hereto for the record. [END]

By fax to Laurence Rivat, IASC

From Walter P. Schuetze; March 12, 1997



RE: IMPAIRMENT

I do not support the Exposure Draft on Impairment that is being sent to the IASC Board for discussion and vote at the Board's next meeting in April. I do not support the idea of value in use as a way to measure the value of an asset for the purpose of determining whether the carrying amount of that asset needs to be adjusted downward because the carrying amount is "impaired." I believe that fair value (market value) should be used.

Value in use allows management of the reporting enterprise to use its judgment in estimating future net cash flows from an asset as opposed to referring to the judgment of the marketplace in establishing fair value. Even in the face of a market-determined value of an asset, value in use may be, and generally will be, a larger amount than fair value. Take, for example, a seat on the New York Stock Exchange. The going price for a seat on the NYSE may be \$500,000, but management may say that the value in use of the seat is \$900,000 because management's estimate of future commissions is more optimistic than the judgment of other bidders for a seat on the Exchange. Thus, if the carrying amount of the seat is \$1 million, a writedown of \$100,000 is indicated using the value in use idea instead of \$500,000 using fair value. The same goes for office buildings, apartment houses, commercial aircraft, auto and truck rental fleets, radio and TV licenses, factories, mines, etc., etc.--indeed, any asset where fair value is less than value in use--which, as a practical matter, means most nonmonetary assets. Using the example of the seat on the NYSE, I think that a writedown of \$500,000 should be made, and that investors will be misled if a writedown of only \$100,000 is recognized.

I can predict with great confidence what will happen using value in use to measure the amount of "impairment." Financial statements will be issued for years with no writedowns of the carrying amounts of assets; then when assets have to be sold to raise money to pay debts or for other reasons, huge losses will be reported; those losses will be the difference between

management's judgment of the value in use of the asset and the market's judgment of the fair value of the asset. Investors will be surprised and shocked. In the USA, we have had a lot of experience in this regard prior to the issuance of FASB Statement 121 in 1995, which Statement requires the use of fair value to measure "impairment." For example, about fifteen years ago when the price of oil fell to about \$9 a barrel, the number of onshore drilling rigs actually being used to drill oil wells fell from about 4,000 to about 1,000, and 3,000 rigs were idled. The fair value-market value of the rigs plummeted. Many public companies that owned rigs did not want to writedown the cost of the rigs; the managements of those companies said that they knew more about the true value of their rigs than did the marketplace. Those managements of course were quite wrong, and eventually huge losses had to be recognized when the rigs were sold for scrap. Also about fifteen years ago, we had a great real estate boom followed by a collapse in the market prices of properties. When the property market collapsed, the managements of companies owning real estate made optimistic assumptions about a market recovery, and they did not want to writedown the cost of their real estate holdings. Those managements of course were quite wrong, and eventually huge losses had to be recognized when the properties were sold, "reorganized," or transferred to the US Federal Government.

It will do no good to say, as is said in the document (in paragraph 23(a) in my copy of Agenda Paper 9A for the April Board meeting) that management should be careful--that management should project cash flows from the asset based on reasonable and supportable assumptions which represent management's best estimate of the probable set of economic conditions that will exist over the remaining useful life of the asset. Owners of assets always are optimistic about the future and the cash flows their assets will produce. External auditors will be unable to require their clients to get marketplace validation of the assumptions used in projecting cash flows and will have to accept their clients' assumptions. The upshot will be that loss recognition in financial statements using management's value in use instead of the marketplace's fair value-market value will be too little, too late, and investors will be misled.

There is another reason why the IASC Board should require the use of fair value-market value in the document on impairment--namely, consistency. Shortly, the Board will be considering a document on accounting for marketable securities. As I understand it, that document will require that

common stocks be marked to market in the balance sheets of owners of those stocks. A common stock, in concept, is the same as any other nonmonetary asset; its value derives from its future cash flows. This can be seen clearly in the case of a company that owns a single asset, for example, an office building; the stock is the building and the building is the stock. In concept, value in use could be used to measure the carrying amount of a common stock held as an asset, for example, the stock of the company that owns the office building, as it can for the office building itself. If value in use were used to measure the carrying amount of common stock, then we would use management's estimate of future cash flows from the stock, that is, future dividends and proceeds from an ultimate sale of the stock, discount those cash flows, and put the resulting amount in the balance sheet. In other words, we would say that the owner of the stock--management of the reporting enterprise--is a better judge of the value of the common stock than is the marketplace where prices are established in real world transactions. That would be an unacceptable proposition as it would relate to common stocks and should be equally unacceptable as it relates to impairment.

I recommend--strongly recommend--that the IASC Board require the use of fair value-market value to measure impairment of the carrying amount of assets, not value in use. That change might cause some delay in the issuance of an Exposure Draft, but that's OK.

I would appreciate your sending a copy of this memorandum to members of the IASC Board prior to the meeting in April.