



Organisation internationale des commissions de valeurs

International Organization of Securities Commissions

Organización internacional de comisiones de valores

Organização internacional das comissões de valores

OICV / IOSCO

March 19, 1998

By Facsimile and Post

Sir Bryan Carsberg
Secretary - General
International Accounting Standards Committee
166 Fleet Street
London EC4A 2DY
United Kingdom

Dear Sir Bryan,

The International Organization of Securities Commissions' (IOSCO) Working Party No. 1 on Multinational Disclosures and Accounting (the Working Party) issued its comment letter, dated November 21, 1997, setting forth the Working Party's comments on the May 1997 Exposure Draft E55, *Impairment of Assets* (E55). The Working Party understands these comments were discussed by the IASC Steering Committee on Impairments (the Steering Committee) during its meeting on November 24 and 25, 1997. As a result of these discussions, the Steering Committee has asked the Working Party to clarify certain comments made in its letter of November 21, 1997.

The only comments repeated herein are those where clarification has been requested by the Steering Committee. The comments the Working Party has been asked to clarify relate to the measurement of the recoverable amount and proposals regarding cash-generating units (CGUs). The additional comments included herein that clarify the original comments of some Working Party members have been presented in **boldface**. The original comments of other Working Party members, including differing views, have not been repeated in this letter. The Working Party notes that all the comments in its letter of November 21, 1997, continue to apply. In addition to clarifying the Working Party's original comments, some Working Party members would like to offer additional comments relating to the disclosure of CGUs.

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MODIFICATION AND CLARIFICATION OF SELECTED PRIOR COMMENTS

1. Measurement of the Recoverable Amount

...The recoverable amount is defined in E55 as the higher of an asset's net selling price and its value in use. Some Working Party members believe the net selling price covers two types of values -- market price and transaction price. These Working Party members believe that it is necessary to clarify the conditions under which the three values (i.e., value in use, market price and transaction price) may be used, depending in particular on the existence of an active and liquid market. These Working Party members believe that the following hierarchy should be applied to determine the recoverable amount when there is an active and liquid market:

- transaction price, if there is a binding sale agreement;
- market price or surrogate (i.e., value based on market transactions and assumptions), except for the measurement of goodwill (in order to avoid the recognition of internally generated goodwill);
- value in use, based on market assumptions, if justification can be provided to override the information provided by an active and liquid market.

When there is no active and liquid market, these Working Party members believe that the recoverable amount of an asset should be determined using the following hierarchy:

- transaction price, if there is a binding sale agreement;
- if not, higher of the value in use and market price.

These Working Party members note that, as it is unlikely that there are active and liquid markets and binding sale agreements and therefore, no transaction price, it is necessary that the future standard gives more guidance on how to determine an asset's market price; in particular, emphasis should be placed on whether the external references are current and the current use of similar references within the industry (provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's value is estimated). For example, if a net selling price for a piece of real estate is based on sales prices of comparable properties, did those other transactions take place within weeks, months or years? These Working Party members believe that the future standard should indicate that there is no conceptual difference between an asset's net selling price and its value in use...

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2. Proposals Regarding Cash-Generating Units

...The Working Party discussed whether additional disclosures regarding the CGUs identified, and their carrying amounts and impairment losses, would provide discipline to the process of grouping assets into CGUs. A majority of the Working Party concluded that expanded disclosures would not be an adequate substitute for additional guidance on the application of this principle as detailed disclosures should not discourage companies from developing smaller, realistic cash generating units and that the disclosure of the carrying amounts and any accumulated impairment of each CGU should be encouraged and not necessarily required (rather than merely required), only for the impaired CGUs and if the information is material on an overall basis...

ADDITIONAL COMMENTS REGARDING DISCLOSURES

The Working Party in its letter of November 21, 1997, noted that a change in the basis used for the goodwill allocation or in the breakdown into CGUs can have an impact on both the carrying amount and the recoverable amount of the CGUs which may offset potential losses with internally generated goodwill or other intangible assets. The Working Party's November 21, 1997, letter communicated several comments regarding the determination of CGUs. Those comments continue to apply. Additionally, noting the importance of determining CGUs consistently from period to period, some Working Party members believe it also is necessary:

- to disclose the description of the nature, reasons and effects of any material change in the goodwill allocation or in the breakdown into CGUs (e.g., information similar to that required by paragraph 71 of IAS 14, *Segment Reporting*);
- in the case of a restructuring, business combination or merger, to disclose at the end of the reporting period during which the transaction occurs:
 - the nature of unrecognized internally generated intangibles and other items which, due to the transaction, will be taken into account in determining the recoverable amount of the combined CGUs;
 - the accumulated recoverable amounts of these unrecognized items at the transaction date; and
 - the effect, if any, on impairment losses of their inclusion in the cash generating unit(s).

These Working Party members further believe that the disclosure of the accumulated carrying amounts and impairment losses of tangible assets, intangible assets and goodwill by categories, which is not linked to the number of CGUs, is valuable information that should be required disclosure.

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Other Working Party members do not support these additional disclosures because while they believe the information may be useful, they question whether such disclosures are cost beneficial. These Working Party members are also concerned that such a requirement would discourage the identification of CGUs at the lowest level of independent cash flows since a greater burden would be placed on those enterprises that identify a larger number of CGUs.

The views of the Working Party should be considered in the context of successful completion of the core set of standards and the significance of concerns of the Working Party members on other aspects of the exposure draft. The Working Party appreciates the opportunity to comment and would be pleased to discuss these comments further.

Sincerely,

A handwritten signature in dark ink, appearing to read "Paul A. Leder", written in a cursive style.

Paul A. Leder
Chair

IOSCO Working Party No. 1



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November 21, 1997

By Facsimile and Post

Sir Bryan Carsberg

Secretary - General

International Accounting Standards Committee

166 Fleet Street

London EC4A 2DY

United Kingdom

Dear Sir Bryan:

The International Organization of Securities Commissions' (IOSCO) Working Party No. 1 on Multinational Disclosures and Accounting and its Accounting and Auditing Subcommittee (the Working Party) have considered the May 1997 Exposure Draft E55, *Impairment of Assets* (E55) issued for comment. The Working Party regrets that it was not able to comment earlier due to its schedule of meetings, but believes that it should summarize views expressed during its discussions to date.

The Working Party supports the IASC's development of a standard on impairment of assets, and believes that such a standard is a necessary component of a comprehensive core set of accounting standards. Before commenting on E55's specific proposals, the Working Party discussed the interaction of this document with other IASC projects. In the course of the Board's discussions while developing E55, there have been frequent references to the Board's objective of developing a sufficiently robust impairment test to permit elimination of any specified maximum life for goodwill and other intangible assets. This objective is noted in paragraph 2(c) of Appendix 3, *Basis for Conclusions*, to E55. Some members of the Working Party do not believe that the standard proposed supports the Board's objective.

These Working Party members hold this view because they do not believe that any impairment standard can be sufficiently robust to support removal of a maximum life for intangible assets. These Working Party members note that extended lives for goodwill and other intangible assets are very difficult to justify without considering, either directly or indirectly, activities subsequent to the initial acquisition date to maintain or enhance the life of the acquired intangible asset. As discussed in connection with the Working Party's comments herein on cash generating units, impairment tests made at a level other than that of an individual asset are likely to incorporate internally generated goodwill or the effects

of post-acquisition activities. These Working Party members do not believe that the standard proposed in E55 supports the Board's intention to remove the twenty year maximum life for goodwill and other acquired intangible assets currently specified in IAS 22, *Business Combinations*.

Other members of the Working Party will consider whether the IASC has achieved this objective when they consider the proposals in E60, *Intangible Assets*. These Working Party members would also like to comment, in respect of E55, on the potential effects of the link existing between the recognition criteria defined in the IASC's project on intangibles and the approach proposed in E55 in respect of intangibles acquired in a business combination. These Working Party members note the interaction of E55 and IAS 22:

- Under IAS 22 goodwill is determined as the residual cost of an acquisition;
- Increasing the amount of goodwill will lead to more extensive use of the complex approach developed in paragraphs 59-61 of E55;
- In paragraph 27 of IAS 22, useful criteria are provided for the separate recognition of assets and liabilities (i.e., the probability of receiving future economic benefits and reliable measurement of cost or fair value); and
- A business combination in itself gives sufficient evidence of the control over the assets.

In view of the above, these Working Party members believe it is not necessary for the IASC to introduce, in its project on intangible assets, the additional control characteristics of the "ability to restrict the access of others to the future economic benefits." (See paragraph 15 of E60, *Intangible Assets*.)

Other Working Party members will consider whether or not they concur with this comment when they comment on E60. The Working Party members who support this comment note that they will reconsider this comment after completion of the standards on intangible assets (see E60) and business combinations (see E61, *Business Combinations*). These concerns about the interaction of E55 with E60 also will be addressed in the Working Party's comment letter on E60.

Additionally, the Working Party offers comments on the following points:

1. Measurement of the recoverable amount;
2. Proposals regarding cash-generating units and allocation of goodwill;
3. Reversal of impairment losses;
4. Recognition and measurement of impairment losses;

5. Other miscellaneous items; and
6. Effective date.

1. Measurement of the Recoverable Amount

As discussed in Question 1 of the *Invitation to Comment* in E55, the IASC has proposed measuring an impaired asset at its recoverable amount, which is defined in paragraphs 5 and 13-40 of E55 as the higher of the asset's net selling price and its value in use. The Working Party does not support this approach, as proposed.

Some Working Party members believe that it is necessary to clarify the conditions under which the three values may be used, depending in particular on the existence of an active and liquid market. These Working Party members believe that the following hierarchy should be applied to determine the recoverable amount when there is an active and liquid market:

- transaction price, if there is a binding sale agreement;
- market price or surrogate, except for the measurement of goodwill (in order to avoid the recognition of internally generated goodwill);
- value in use, if justification can be provided to override the information provided by an active and liquid market.

When there is no active and liquid market, these Working Party members believe that the recoverable amount of an asset should be determined using the following hierarchy:

- transaction price, if there is a binding sale agreement;
- if not, higher of the value in use and net selling price, as proposed in the exposure draft.

These Working Party members note that, as it is unlikely that there are active and liquid markets and binding sale agreements, it is necessary that the future standard give more guidance on how to determine an asset's net selling price; in particular, emphasis should be placed on whether the external references are current and the current use of similar assets within the industry. For example, if a net selling price for a piece of real estate is based on sales prices of comparable properties, did those other transactions take place within weeks, months or years?

Other Working Party members believe that once an asset has been identified as impaired, the objective, in all circumstances, should be to remeasure the asset at its fair value. The method used to estimate fair value will vary depending on the nature of the asset. While projection of expected future cash flows may be necessary to estimate fair value in the

absence of an observable market price, these Working Party members believe the objective of this exercise should be to estimate a market value, not an entity-specific value.

These Working Party members support an approach for remeasuring impaired assets at their fair value for many of the reasons discussed in paragraph 15 of Appendix 3 to E55. They believe a hierarchy should look first to remeasure the impaired asset, based on market values (perhaps on a net selling price basis) and, where such information is not obtainable or reliable, then to projections of future cash flows.

These Working Party members also question the basis for the statement on page 4 of E55 that in many cases, the approach based on "the higher of net selling price and value in use" and the approach based on "fair value" will lead to the same or similar conclusions. This conclusion appears to be inconsistent with the discussion in paragraph 16 of Appendix 3 of E55 regarding the purpose of value in use as computation of an entity-specific value. They believe these two approaches may not lead to similar conclusions unless the objective of computing value in use is stated explicitly to be estimating the current market value of the asset. This would require, for example, use of market based assumptions rather than including entity-specific efficiencies or "synergies" expected to be realized.

2. Proposals Regarding Cash-Generating Units and Allocation of Goodwill

In its discussions, the Working Party's members have expressed significant concern that E55's provisions for use of a cash-generating unit (CGU) to test for and measure impairment may be used to mask significant existing impairments of assets (or groups of assets) within the CGU. While the Working Party acknowledges that it may be necessary to group assets for impairment assessment and measurement, it does not believe that the definition of a CGU is sufficiently clear.

The notion of a cash-generating unit is an important concept as the breakdown into cash-generating units constitutes the real measurement basis for an often significant part of the assets (tangible and intangible assets, goodwill), even though that basis is not used for the presentation on the balance sheet. Working Party members are concerned that the approach in E55 will encourage incorporation of post-acquisition factors into the measurement of the recoverable amount of the CGU and therefore fail to recognize impairments that have actually occurred at a level below the CGU. For example, in principle, the impairment review performed at each reporting date should not take into account the value of internally generated goodwill or of non-recognized internally generated intangible assets. Nevertheless, this is likely to occur when the recoverable amount of all the tangible and intangible assets (including goodwill) is determined on a CGU basis, rather than at the level of the individual asset.

The Working Party discussed whether additional disclosures regarding the CGUs identified, and their carrying amounts and impairment losses, would provide discipline to the process of grouping assets into CGUs. A majority of the Working Party concluded that expanded disclosures would not be an adequate substitute for additional guidance on

the application of this principle as detailed disclosures should not discourage companies from developing smaller, realistic cash generating units.

The Working Party members believe that:

- (a) The discussion of identification of CGUs in paragraphs 46-50 should be expanded to discuss the dangers of not performing an impairment assessment at the lowest possible level of largely independent cash flows. These dangers include incorporation of internally generated goodwill in an impairment assessment.

Examples of the type of guidance that could be provided include indicating that a CGU normally would be a lower level of aggregation than a segment under IAS 14 (revised), *Reporting Financial Information by Segment*, for example, a product line rather than an entire division; and to suggest looking no higher than the level at which management is held accountable for performance measures (e.g., region for which sales are reported separately within an enterprise).

- (b) When an enterprise has tested for impairment one or more CGUs, it should provide some description of how it determined the CGU (e.g., for a retail operation, each separate location, a district or regional level).

This disclosure also should describe the basis used for the allocation of goodwill and corporate assets (e.g., prior year's relative revenues, operating profit, original relative fair value, etc.). The Working Party notes that the discussion in paragraphs 49-50 permits a great deal of flexibility in this area indicating that CGUs should "include the carrying amount of all assets that can be directly attributed, or allocated on a reasonable and consistent basis" and believes that the significance of this allocation to the determination of a CGU's recoverable amount supports requiring at least a brief discussion of the method used.

- (c) The principles regarding identification of CGUs should state clearly that both (1) the determination of CGUs is a matter of fact not accounting policy and, barring changes in facts, (2) this determination must be made consistently from period to period.

Some Working Party members also believe that, in addition to the above, the following requirements should be established in respect of CGUs:

- (d) The qualitative information described in (b), above, should be disclosed regardless of whether an enterprise has tested one or more CGUs for impairment;

- (e) The carrying amount and the accumulated impairment losses of tangible assets, intangible assets and goodwill always should be disclosed, if the amounts of those assets are material to the enterprise's financial statements;
- (f) The disclosure of the carrying amounts and any accumulated impairment of each CGU should be encouraged, if not required;
- (g) The number of CGUs should be disclosed; and
- (h) Some members of the Working Party believe that disclosure of the following information should be required when the measurement basis of CGUs has been modified due to restructurings, business combinations or mergers:
 - the nature of the items which in future will be taken into account in determining the recoverable amount;
 - the recoverable amount of these items at the measurement date; and
 - the effect, if any, on the measurement of impairment losses of the inclusion of internally generated intangibles and other items normally not recognized.

The measurement basis (i.e., grouping of assets in CGUs) may be modified due to restructurings, business combinations or mergers, and these events may result in the inclusion of internally generated goodwill, or internally generated intangible assets that otherwise would not be recognized, in effect offsetting impairment losses.

Paragraph 29 of E55 requires that "when an enterprise can no longer identify the cash inflows relating to the asset that was initially recognized, it is likely that the enterprise will have to determine the recoverable amount not for the individual asset but for the cash-generating units to which the asset belongs."

Other Working Party members did not support adding the specific additional disclosure requirements discussed in (d) through (h). These Working Party members were concerned that such a requirement would discourage identification of CGUs at the lowest level of independent cash flows since a greater burden would be placed on those enterprises that identify a larger number of CGUs.

3. Reversal of Impairment Losses

As discussed in Questions 5 and 6 of the *Invitation to Comment* in E55, the Board proposes requiring reversals of impairment losses recognized in prior years if there has been a change in the estimates used to determine the recoverable amount of the impaired asset(s). However, goodwill impairments would be reversed only if the external event that caused recognition of the impairment has reversed.

Some Working Party members support an approach that requires reversals of previously recognized impairments. These Working Party members support the conclusion in paragraph 70 which requires that reversals of an impairment loss should be recognized if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. However, they believe that the IASC should consider giving additional guidance as to the meaning of the phrase "change in estimates." For instance, it seems necessary to make clearer that a change in the market price of a previously impaired asset is a change in estimate, when the impairment in the previous year's financial statements has been made on the basis of the market price.

The Working Party members who support reversals of impairment question the operationality of the requirement to reverse an impairment loss recognized for goodwill and other intangible assets for which no active market exists if, and only if, the specific external event that caused the recognition of the impairment loss has reversed (see paragraph 77 of E55). As there is no precise definition of an external event, it appears that a change in the (market-based) discount rate does not allow an enterprise to reverse an impairment loss. These Working Party Members believe that this conclusion would not be consistent with the approaches proposed by other IASC projects, which provide that both positive and negative effects of the changes in discount rate must be taken into account.¹ These Working Party members also believe that the concept of an "external event" should be better defined.

The Working Party members who support reversals of impairments and are prepared to accept the definition of the recoverable amount as the higher of net selling price and value in use (subject to the comments in section 1) believe that clarification concerning the possibility of a reversal may be necessary. The Working Party members who are prepared to accept this definition consider however, that clarification concerning the possibility of a reversal may be necessary when, in the previous year's financial statements, an asset has been impaired on the basis of its net selling price (higher than the value in use) and in the reporting year the asset's value in use becomes higher than its net selling price.

In addition, those Working Party members believe that when the net selling price is used to measure the recoverable amount, it would be difficult, if not impossible, to identify the reasons for its change, which could result in different accounting treatments, depending on the nature of the value used for the impairment calculation.

Other Working Party members do not support any reversal of impairments. These Working Party members believe that an impairment should be regarded as establishing a new historical cost for the asset (including resetting the accumulated depreciation and

¹ See for example, the IASC's March 1997 Discussion Paper, *Accounting for Financial Assets and Financial Liabilities*, E54, *Employee Benefits*, and E59, *Provisions and Contingencies*.

amortization). They believe that reversal of impairments is the equivalent of revaluation accounting and therefore, should be recognized only in the context of application of the allowed alternative treatment in IAS 16, *Property, Plant and Equipment*. They have difficulty separating revisions of estimates due to subsequent changes in circumstances from subsequent changes in value that give rise to upward revaluation under IAS 16's allowed alternative.

Those who object to reversals of impairment losses do distinguish between reversals which are based on changes in estimates and corrections of errors. They point out that if an enterprise discovers a fundamental error in the original impairment computation, correction of that error in accordance with IAS 8, *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, would be required.

4. Recognition and Measurement of Impairment Losses

Paragraph 42 requires that "when the amount estimated for the impairment loss is greater than the carrying amount of the asset, an enterprise should recognize a liability if, and only if, that is required by other International Accounting Standards."

The Working Party believes it would be helpful to state explicitly that an asset should not be recorded at a negative value.

Some Working Party members question whether this section would prohibit an investment in a subsidiary to be recorded at a negative value on the asset side when the subsidiary has a negative shareholders' equity.

5. Other Miscellaneous Items

- (a) **Costs of Disposal:** The Working Party notes the statement in paragraphs 20 and 21 that asset disposal costs should not include previously recorded liabilities or restructuring costs. The Working Party supports this conclusion and its inclusion in the standard.
- (b) **Income Taxes:** As discussed in paragraphs 50-58 of Appendix 3 to E55, the Board concluded that impairments should be computed on a pre-tax rather than net-of-tax basis. The example included following paragraph 57 illustrates the complexity of applying a post-tax approach that would require gross-up of goodwill for a notional tax amount. Some members of the Working Party expressed support for the Board's conclusions and their belief that permitting or requiring a post-tax computation would introduce a level of complexity that is not desirable and would reduce the comparability of different enterprises' computations for similar assets.
- (c) **Discount Rate:** The Working Party also noted that it would support the IASC undertaking a separate project to address the full range of issues relating to the use of discounting in financial accounting. The Working Party would not expect such a

project to be carried out before the completion of the core standards. The objective of the project would be to promote consistency in both the circumstances in which discounting is used and the basis on which it is applied, e.g., the selection of a discount rate.

6. Effective Date

Transitional provisions and effective dates are an IOSCO suspense issue.

Some members of the Working Party may have additional comments that they will send to you. The views of the Working Party should be considered in the context of successful completion of the core set of standards and the significance of concerns of certain Working Party members on other aspects of the exposure draft. The Working Party appreciates the opportunity to comment and would be pleased to discuss these comments further.

Sincerely,

A handwritten signature in dark ink, appearing to read 'P. A. Leder', written in a cursive style.

Paul A. Leder

Chair

IOSCO Working Party No. 1

and

on behalf of the

Accounting and Auditing

Subcommittee of IOSCO Working

Party No. 1