

Date:
20 August 1997

Your Ref:

Our Ref:
REL/JP/374-97

Sir Bryan Carsberg
Secretary-General
International Accounting Standards Committee
167 Fleet Street
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Dear Sir Bryan

E55 Impairment of assets

I enclose a memorandum of comment setting out the Institute's views on the exposure draft of a proposed international accounting standard on impairment of assets.

If there are any points on which further discussion would be helpful, please let me know.

Yours sincerely

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**MEMORANDUM OF COMMENT
ON THE PROPOSED INTERNATIONAL ACCOUNTING STANDARD
IMPAIRMENT OF ASSETS**

Introduction

1. We have reviewed the exposure draft on impairment of assets (E55) issued for comment by the IASC and our comments are set out in this memorandum. We deal first with a number of general points. We then comment on the specific issues on which views are invited. Finally, we refer to some other matters that will need to be addressed before the proposals are issued as an international accounting standard.
2. In view of the possibility that the proposals may have an effect on the development of a future standard on accounting for impairment in the UK, we are sending a copy of this memorandum to the Accounting Standards Board.

GENERAL

3. We welcome the exposure draft as a thought-provoking contribution to a continuing debate. We agree that impairment of assets is important and that it should be communicated to users of financial statements, notwithstanding the subjectivity that will often be involved in the measurement of impairment.
4. Our principal concerns are that:
 - The proposed standard would involve departures from historical cost accounting that have not been fully debated and are likely to cause conceptual difficulties. We question the effectiveness of a standard on impairment before resolution of such issues as the use of valuations within the historical cost model, the purpose and basis of depreciation and the role of discounting. (Paragraphs 6, 12 and 16)
 - The measurement of impairment is unavoidably subjective, particularly in respect of the determination of cash-generating units, the allocation of goodwill and central cashflows, and the choice of an appropriate discount rate. (Paragraphs 15, 16 and 17)



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- Unless the subjectivity involved is properly acknowledged, there may be a gap between the degree of comfort that users will expect to draw from information about impaired values and the work that preparers and auditors will be able to perform to support that information. (Paragraphs 16 and 17)
- Providing the information required for the proposed disclosures will often be onerous for preparers and may involve the release of commercially sensitive information. Disclosures should be by class of asset rather than by individual asset or cash generating unit and are unnecessary when no impairment loss is recognised. (Paragraphs 19 to 22)
- E55 does not address the impact on asset values that may occur due to environmental factors, where uncertainty of timing and measurement and the relationships with provisions may cause particular difficulties. Guidance in this area should be developed (see Appendix).

SPECIFIC ISSUES

Measurement of recoverable amount

Q1. 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)*

5. We support the approach in option (a).

Q2. 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)?

6. Yes. As *net selling price* is implicitly a present value, a comparable *value in use* must also be measured on a discounted cashflow basis. However, as neither historical cost, nor depreciation, which is an allocation of historical cost, recognise the time value of money, this approach gives rise to conceptual inconsistencies.

Assets held for disposal

- Q3 *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)?*
7. Yes. Paragraph 26 explains the situation succinctly and should be included in the proposed international accounting standard.

Recognition of impairment losses

- Q4. *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.

8. We find the question is not sufficiently clear for us to provide a response. It appears that both conditions need to be satisfied for impairment to be recognised, in which case the words “only if” in sub-paragraph (b) should be deleted. Their inclusion is otherwise in conflict with use of the word “whenever” in sub-paragraph (a).

Reversals of impairment losses

- Q5. *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 estimate 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)?*
9. We consider that an impairment loss recognised in prior years in respect of an asset carried on an historical cost basis should be reversed, not on a change of *estimates*, which might result in excessive volatility, but only on a change of *circumstances* which gave rise to the impairment. We therefore prefer the wording in IAS16, as described in paragraph 83 of Appendix 3. The proposed standard should also include one set of criteria that would apply, not only to goodwill and intangibles, but to all tangible fixed assets and fixed asset investments.

Q6. Do you agree that an impairment loss recognised for goodwill and other intangibles 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)?

10. Yes. See our answer to Question 5 above.

Scope

Q7. 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)?

11. Yes.

Identifying a potentially impaired asset

Q8. 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 that recoverable amount whenever there is a significant risk that the asset is impaired?

12. Yes. However, paragraph 8(a) should refer to declines as a result of *normal business use* (wear and tear) rather than *depreciation* (allocation of cost). We also note that, when discussing internal sources of information, paragraph 8(e) mentions *changes expected to take place*. This appears to be a clear reference to management intent which, in most other areas, the IASC considers irrelevant.

13. It would be helpful for the proposed standard to provide a definition for the term *impairment*, if only to distinguish *impairment* from *depreciation*. We suggest the following definition:

‘An asset has suffered an impairment when its recoverable value is less than its carrying value’.

Net selling price

Q9. 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) (paragraph 5 and 19-21 of the exposure draft and paragraph 35 of the basis for conclusions)?*
14. Yes. However, it should be stated that the recoverable amount should take into account any proper marketing necessary to dispose of the asset. In this connection, we draw your attention to the explanation in the Appraisal and Valuation Manual issued in the UK by the Royal Institution of Chartered Surveyors:

‘after proper marketing’ means that the asset would be exposed to the market in the most appropriate manner to effect its disposal at the best price reasonably obtainable in accordance with the market value definition. The length of exposure time may vary with market conditions, but must be sufficient to allow the asset to be brought to the attention of an adequate number of potential purchasers. The exposure period occurs prior to the valuation date.

Value in use

Q10. Do you agree with the proposed requirements and guidance in the exposure draft for:

- (a) *the basis for estimates of future cash flows (paragraph 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)?*
15. Yes, as regards Questions 10(a) and (b). However, the example in paragraph 29 illustrates the difficulty of applying these rules in practice and we doubt whether they will be as robust as the IASC appears to believe.
16. No, as regards Question 10(c). Guidance should be provided as to the principle involved. Selection of the discount rate is probably the single most important and subjective area of the proposed standard. A small change in the discount rate adopted can very significantly affect the *value in use* derived for the asset. We consider that the proposed guidance is insufficiently helpful to preparers in deciding how to select the appropriate discount rate. For example, practical difficulties may arise in determining the *risks specific to the asset* and what is *an investment of equal risk*.

Cash-generating units

Q11. 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)?

- Q12. *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)?*
- Q13. *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 cash-generating unit (paragraphs 59-61 of the exposure draft and paragraphs 79-81 of the basis for conclusions)?*
- Q14. *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)?*
17. Yes, although we are concerned about the subjectivity involved. The *bottom-up* and *top down* approach may make it easier for enterprises to avoid recognising impairment losses for purchased goodwill. Nevertheless, we do foresee situations where it may reasonably be claimed that:
- (a) the whole business is a cash-generating unit; or
 - (b) the generation of income depends on the interdependence of the overall asset network.

The proposed standard should acknowledge that such situations might arise.

Disclosure

- Q15. *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)?*
18. Yes.
- Q16. *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 amounts is based on 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 in 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)

19. We do not agree with the disclosure requirements in paragraph 82 for each *individual* asset or cash-generating unit, as these could be very onerous and are likely to involve commercially sensitive information. We do, however, support the disclosures proposed in paragraphs 82(a) and (b) if made by *class* of asset.
20. We do not support the disclosures in paragraphs 82(c) and (d) in any circumstances.
21. We agree that enterprises should not be required to provide the additional disclosures set out in Question 16(a) to (d)

Q17. 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 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)?

22. We do not agree with the disclosure requirements proposed in paragraphs 83-84. For example, if both management and auditors are satisfied that no impairment loss should be recognised, it is very unclear what message the information in paragraph 83 is supposed to give to the capital markets.
23. We agree that an enterprise should not be required to disclose the information specified in Questions 17(a) to (c).

Q18. Do you agree with the disclosure requirements in paragraph 85 of the exposure draft (paragraphs 24 and 100-101 of the basis for conclusions)?

24. No. The first part of paragraph 85 is concerned with measurement rather than disclosure. The second part seems to be designed purely as an anti-avoidance measure and should not be necessary.

Q19. 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.

25. No. We consider that the way in which an entity defines its cash-generating units may have a significant effect on measurement and should accordingly be disclosed as an accounting policy in the form of a general description of the basis used.

Q20. Should an enterprise be required to disclose any information other than that discussed in questions 15-19 to the invitation to comment?

26. No.

Appendices

Q21. Should any material in Appendix 1 be amended or deleted? Should any further guidance be added to the appendix?

27. Yes. We suggest an expansion of the examples as they do not explore the effect of the accounting treatments in subsequent years. We are also concerned about the effect of unwinding the discount. The IASC's proposed approach leads to a mismatch between depreciation and the unwinding of the discount which may result in profits being recorded in future years. We consider that the inherent potential for distortion in future years needs to be addressed.

Q22. Do you agree with the consequential changes to IAS16, Property, plant and equipment (Appendix 2)?

28. Yes.

Other comments

Q23. Do you have any other comments on the proposed international accounting standard?

29. Yes. The IASC should consider the impact of its current proposals on other standards. For example, paragraph 36 of IAS 11 on Construction contracts makes no mention of discounting in recognising losses.

ISSUES RELATING TO ENVIRONMENTAL IMPAIRMENT

Introduction

1. Whilst the general principles of reviewing asset values for possible impairment should apply equally to assets affected by environmental factors, this type of impairment often carries particular uncertainties regarding timescale and amount and E55 does not address problems involved in measuring the related impact on asset values. Guidance in this area should be developed. For example, it would be helpful to illustrate the points made in paragraphs 32 and 33 about the interplay of provisions and asset impairment using an environmental example.

Management intent

2. The exposure draft attaches little importance to the relevance of management intent in determining the appropriate accounting treatment. A bias against such factors is difficult to justify in the case of environmental impairment, where an enterprise's plans for repair or abandonment are likely to be a key consideration.

The 'stigma' effect

3. Measurement of an environmentally impaired asset may be affected by:
 - delayed disposal, due to the need to deal with contamination, resulting in increased interest charges;
 - direct costs of overcoming the problems of contamination;
 - uncertainties due to the possibility of improvement in related technology or changes in legislation; and
 - risks arising from the stigma effect, deterring potential purchasers and resulting in a more restricted market.
4. Stigma is an aspect of asset contamination resulting from various intangible factors ranging from possible public liability and fear of additional health hazards to fear of the unknown. It might be defined as that part of any diminution in value attributable to the existence of contamination which exceeds the costs attributable to:
 - remediation of the asset;
 - the prevention of future contamination;
 - any known penalties or civil liabilities;
 - insurance; and
 - future monitoring.

In practice, the stigma effect may be recognised by applying a further discount to the value of an asset after allowing for all expected remediation costs.

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